PREFATORY NOTE

These transcripts have been produced from the original raw transcripts in the FOMC Secretariat's files. The Secretariat has lightly edited the originals to facilitate the reader's understanding. Where one or more words were missed or garbled in the transcription, the notation "unintelligible" has been inserted. In some instances, words have been added in brackets to complete a speaker's thought or to correct an obvious transcription error or misstatement.

Errors undoubtedly remain. The raw transcripts were not fully edited for accuracy at the time they were produced because they were intended only as an aid to the Secretariat in preparing the records of the Committee's policy actions. The edited transcripts have not been reviewed by present or past members of the Committee.

Aside from the editing to facilitate the reader's understanding, the only deletions involve a very small amount of confidential information regarding foreign central banks, businesses, and persons that are identified or identifiable. Deleted passages are indicated by gaps in the text. All information deleted in this manner is exempt from disclosure under applicable provisions of the Freedom of Information Act.

Meeting of the Federal Open Market Committee

August 19, 1986

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, August 19, 1986, at 9:00 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Heller
Mrs. Horn
Mr. Johnson
Mr. Melzer
Mr. Morris
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Boehne, Keehn, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, Forrestal, and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Bernard, Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Balbach, T. Davis, Kohn, Lindsey, and Prell, Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account

Mr. Cross, Manager for Foreign Operations, System Open Market Account

Mr. Coyne, Assistant to the Board, Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Promisel, Senior Associate Director, Division of International Finance, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International Finance, Board of Governors
Mrs. Loney, Economist, Office of the Staff Director for Monetary and Financial Policy, Board of Governors
Mrs. Low, Open Market Secretariat Assistant, Board of Governors

Mr. Wallace, First Vice President, Federal Reserve Bank of Dallas

Mr. Fousek, Executive Vice President, Federal Reserve Bank of New York

Messrs. Broaddus, Lang, Scadding, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Richmond, Philadelphia, San Francisco, and Chicago, respectively

Messrs. McNees, Pearce, and Sniderman, Vice Presidents, Federal Reserve Banks of Boston, Dallas, and Cleveland, respectively

Ms. Meulendyke, Manager, Federal Reserve Bank of New York

Mr. Weber, Senior Economist, and Ms. Rosenbaum, Economist Federal Reserve Banks of Minneapolis and Atlanta, respectively

Transcript of Federal Open Market Committee Meeting of
August 19, 1986

[Secretary's Note: The minutes of the July meeting were approved at this point.]

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Are there any questions or comments?

MR. FORRESTAL. Sam, do you think that the market is looking for further U.S. easing at this point?

MR. CROSS. I think there is that expectation, but the timing is difficult to say; certainly, looking over a period of some weeks I think there is [that expectation].

CHAIRMAN VOLCKER. No other observations? We haven't got any transactions to ratify do we?

MR. CROSS. We have nothing.

CHAIRMAN VOLCKER. I might take up at this point the Mexican situation. We have [distributed to the Committee] a memorandum in which you'll see a proposal described as bridge financing. The Mexicans don't like to call it a bridge but a contingency support [facility]. It was agreed to in principle some time ago and was pretty much put together after a lot of discussion last week. We had some difficulty putting it together. We are sort of in the middle, satisfying the BIS people on the one side and the Mexicans on the other side. I'm just glancing through this memorandum to see what it says and what it doesn't say--it does say $1.1 billion. We were thinking of $1 billion, but we added the kind of voluntary contributions of the Europeans and the Latin Americans. We came up with the idea that the United States would be 50/50 with the others and they came up with a little more than $500 million to make it $1.1 billion [in total]. The U.S. participation will be some combination of Federal Reserve and Treasury participation, which hasn't been finally resolved yet; I think it will be resolved today.

The banks were not very eager about this initially but agreed to go ahead on the basic conditions that were described in this memorandum. They would go ahead with their bridge [financing] after they reach an agreement in principle on the basic bank loan--not only an agreement in principle on the terms of that loan but agreement on participation of the so-called critical mass, which is in the neighborhood of 90 percent participation. That is going to take, at the very least, some weeks to achieve. There was an original target set for the first week in September, but enough time has passed already that I would be extremely surprised if it is reached in the first week in September. That negotiation on the basic bank loan is really only going to begin tomorrow and if we get it done before the IMF meeting, I think we will be fortunate. One of the terms of the banks' participation is that the officials come in first and go out last in terms of the initiation [of the loan] and the conclusion. That doesn't mean that the amount of the official facility has to be as large as theirs for the whole time that it is outstanding. The banks originally wanted to come in on the same terms and conditions that the officials did, but that violated another principle that we follow: that the official bridge be paid off by official money--IMF payments and World Bank payments to the Mexicans. There isn't going to be enough of that money to also pay off the commercial banks. The logic is that the bridge part of the commercial bank participation gets paid off by the basic loan that the commercial banks presumably will make. And that is why they have tied it down by saying they are not going to participate in the bridge until they have agreement in principle on the basic loan. That makes the participants in the bridge pretty safe. Sometimes these things have been done just by the advisory committee, which is about 13 banks, but this time they hope to involve 40 to 50 banks. They will get all the major banks involved in the Mexican credit to participate. There was quite a lot of difficulty getting full participation, even in the advisory committee, on the agreement in principle. The have been very reluctant about this whole operation. The were reluctant at one point. The were bargaining with their own government about some other supervisory matters. That has all been cleared up, in principle. Then we ran into delays on the official bridge.

The most important substantive question that arose from the Mexicans is this: Mr. Mancera, the Governor of the Bank of Mexico, told me that if the bridge is going to be repaid out of IMF and World Bank money on the time schedule anticipated for that money--and the bridge is going to be repaid pretty much by November and December--that's just when Mexico is going to need the money the most if the bank loan is not concluded by December. We have been assuming that the target date for the bank loan--the target date in the sense of actual disbursement of the first tranche of the bank loan--is December. He is, with some justice, very suspicious of whether that date can be met. And he says: If that date cannot be met, what do I do? By December or January the official part, at least, will be pretty much repaid. I am going to be losing money all during this period from a balance of payments deficit. It doesn't look like [the plan] is adequately designed to meet my needs. He had some other complaints too, including the cost, but we got those resolved last week. We got them resolved with my intervention, frankly, which raises a matter I directed just to the Committee. I think he has a point, if the bank loan is delayed--which is not what we plan, but I think one has to assume that it might not come through in December and might be delayed until January or even possibly early February. If it's delayed longer than that, I think we have a big failure on our hands. I have a piece of paper, which you might want to glance at, that shows precisely what I told him because he wanted it in writing. [Turning to staff:] Why don't you give the members of the Committee my paper? But I would like to have it back. You have it? Well, I would like to have this back when you have read it because I don't think this is something we want in the public domain at this point. You can just take a minute to read it. I wanted to meet what seemed to me his legitimate concerns about what happens if the bank loan doesn't come through by December. So I told him that I personally would be willing to recommend to the Open Market Committee--as you will see this is hedged--that if their program is on track and if the bank loan is in fact negotiated and the only real problem is that the bank loan is going to be dispersed in January, let's say, instead of in December, that we would provide, on our own, permission for a drawing upon the existing swap facility with the Bank of Mexico. That would presumably be toward December or January, until the bank loan is paid out in the amount I discussed--let's say $250 to $300 million. Obviously that could be changed, but I discussed that order of magnitude and that provided him with enough reassurance so that he agreed with the whole thing.

I told him I would report this to you. I don't expect any action; it would be inappropriate to take any action at this point. In fact, I don't think we can take action because it's all a contingency plan. But if you have some fundamental concern about this we ought to know about it because it removes the point that reassured him to go on with the whole bridge. We also made some other adjustments to help satisfy some of his concerns. The BIS wants to charge him which is standard BIS practice. That is not unexpected; that has been their standard practice. But then they wanted to charge a

I also told him that as far as we were concerned, he could have drawings on our swap facility at the Treasury bill rate, which is our standard practice. There is nothing unusual about that, except that I think once or maybe twice--just once?--when we participated in a bridge of this sort we charged just to conform because everybody else was charging We were tentatively thinking of doing that this time, but we went back to our usual practice of not charging any spread. So he would get our portion [at the bill rate]; I don't know what the Treasury is going to do at this point. That will force the Treasury, I guess, to do the same, so on our half of the official bridge or one third of the total he will pay no spread. That calmed him down about the fact that this whole thing was costing the Mexicans money. There is a back-up facility for the official bridge. If everything fell apart--if, as would be the normal expectation, they haven't paid through IMF drawings and the money they get from the World Bank--an arrangement has been made, similar to an arrangement that was made with Mexico in 1982 when a bridge was provided, The whole agreement hasn't been signed yet, but I don't think there are any open issues anymore. Are there, Mr. Bradfield?

MR. BRADFIELD. Basically, that's correct. We still have the process of getting final comments, but it's basically agreed.

CHAIRMAN VOLCKER. We will get the actual details of the agreement written out. I think it is in place, basically. Exactly when they will draw upon it is not clear to me. Mr. Mancera wasn't too eager to draw on it before he had to because it costs him money. On the other hand, they want to show adequate reserves at the end of August because that's one of the few dates during the year when they publish their reserves. They will "publish" in this case by a speech by the President of Mexico, I understand, on September 1. They actually publish it the very next day on this one occasion during the year and they want to show adequate reserves as of August 31. That raises a different question, which I will return to in a moment. As I say, this is all set--provided this Committee doesn't forcibly object to looking sympathetically at a request for a drawing in, let's say, the latter part of November or December if the bank loan doesn't go through [by then]. That would basically be a two- or three-month drawing. I have told him that I am prepared to recommend such a drawing to you at that time if such a situation should develop--that is, if the bank loan isn't dispersed. As noted in my memorandum: In the context of progress being made in carrying out the Mexican economic program and in light of the agreement by the bank advisory committee on a commercial bank new money facility and progress toward concluding that agreement at an early date--under those particular conditions--I would recommend that we extend to them, all on our own, a short-term swap for two or three months until it can be repaid. The payout would be from official money but, in fact, the payout would be from the bank loan if it came through, let's say January 15 or so; if that's the first time they had the money, they would pay it out of that. At that point they would have adequate money.

So, the first question I will raise with you is whether you are prepared to receive that recommendation in a friendly spirit should the conditions arise in November or December. As I said, I don't want any official action but I thought I should know if you were in basically an unsympathetic mood and I think you should know about this in all fairness. I will interpret silence as basically a sympathetic mood, I warn you. If that is wrong, please enlighten me.

MS. SEGER. Is this tax reform package going to cool the commercial banks' enthusiasm for this kind of thing even further or am I reading press accounts wrongly?

CHAIRMAN VOLCKER. Oh, I am sure that some of the banks will raise the question. The part of the tax reform package that directly affects this is the treatment of foreign tax credits and I am not exactly sure how they finally resolved that. The Senate bill, I think, had a reasonably satisfactory division. I think that was cut back but I don't think it was cut back far enough to--

MR. TRUMAN. It's short of the Senate bill.

MR. BRADFIELD. I think they still allowed the 3-year transition if they continue to do anything and then a phase out of 5 years instead of the unlimited time for the Baker countries and 10 years for the non-Baker countries. They have put it at 5 years for all countries; they have expanded the list of countries eligible for the first grace period, and there is a phase-out period for 15 to 34 countries. So there shouldn't be any immediate impact on the willingness to lend overseas in these kinds of arrangements--at least for three years, and perhaps for as much as 5 years.

CHAIRMAN VOLCKER. But they will argue that it's a problem because, whatever this will be, it will be a 10-year loan or a 12-year loan and this favorable treatment will only be for 5 years.

MR. BRADFIELD. Five years, but it's phased out at 20 percent a year after that, so it's 80 percent after the [fifth] year and so on.

CHAIRMAN VOLCKER. It won't help, but I don't think it will make it impossible. The theory of the phase out is, in part, that that gives the foreign countries time to adjust their own laws so that they don't have the withholding tax in the first place--or such a punitive withholding tax anyway. It costs them revenue so it is an additional problem, but we hope not an insurmountable one.

MR. GUFFEY. You spoke of the September 1 date to publish reserves. That has nothing to do with this? There will be no drawing on this?

CHAIRMAN VOLCKER. Well, there might be, so I want to return to that. It's really different from this question, but it also might involve a drawing on the swap. I take it that this doesn't seem unreasonable. I don't know exactly what their reserves are now, but the indications are that on August 31st they would like to show around It's not in their interest to show too many reserves because that would cool off the banks. That's one point of view. On the other hand, they are afraid that showing too small an amount of reserves will frighten people in Mexico and raise concerns on that side. So, it's kind of a balancing act.

In 1982 we did something when the particular conditions that existed in the waning months before the election in 1982 were that they were running out of reserves but felt unable to take any action because of the pending election in August. Even if they do the planned disbursement of the official bridge, that would be $850 million in the first tranche. This could be changed; it isn't crucial. But what we were thinking about, notionally anyway, is drawing $850 million of the $1.1 billion fairly promptly and drawing the last $250 million probably simultaneously with the bank bridge, which would likely be in the latter part of September as things look now. When I look at this it would not hurt my conscience too much if we provided something, if they really needed it, in terms of our swap over the end of August in anticipation of drawing upon this bridge. It's a little less window dressing under those circumstances because it's not that we're putting the money in and taking it out right away; we're just speeding up the disbursement that would take place under this official bridge anyway. Now, whether that will be necessary or desirable simply has to wait for more conversations with them. But I guess we can decide this. We have a Foreign Currency Subcommittee that would ordinarily do these things or I do them myself in the absence of the Foreign Currency Subcommittee so long as it's in line with the Committee's guidelines. But I just wanted to raise this issue with you and see whether there would be any overwhelming objections to doing that if it seemed desirable in the light of their particular needs and the anticipated drawings on the bridge a few weeks later.

MR. JOHNSON. Who is this designed to impress?

CHAIRMAN VOLCKER. From their viewpoint, they are concerned about impressing the Mexican public. What they are specifically afraid of is that if they show too low a reserve figure on August 31 that will contribute to capital flight. There would be concern that they really don't have enough money to get through this period and it would undermine confidence within Mexico and make their problem more complicated by fomenting capital flight. That's the way they look at it. But I do think there is this other concern that an unduly large reserve position in the eyes of the banks will only encourage the banks to say: There's no great urgency about our reaching an agreement and maybe they don't need so much money after all. Those are the two things that have to be balanced. I'm not certain of this, but I don't see why there would be any announcement of when the drawing takes place on this regular facility. So I assume that people will interpret the reserve figure at the end of August, if it looks as large as as already including a drawing on the bridge. So I don't know that it means all that much one way or the other.

MS. SEGER. How low are their reserves likely to be at the end of this month without this infusion? Is there any feel for that?

CHAIRMAN VOLCKER. Well, their reserves at the end of July were what?

MR. TRUMAN.

CHAIRMAN VOLCKER. And I would guess, although I just don't know, that they would probably lose at least in a month--that would be a fair guess--which would take them down to leaving them if that's what they want. But that's just a guess. And that includes some nonusable reserves. Their usable reserves are under

MR. TRUMAN. Actually, Mr. Chairman, I think the does not include all of the nonusable reserves. So that may be an underestimate of the total reserves.

CHAIRMAN VOLCKER. Well, we don't know precisely.

MR. TRUMAN. They include silver and a few things like that, but--

CHAIRMAN VOLCKER. You put the family tableware in the public [unintelligible], I guess. If the drawing is big enough it does, under our normal rules, require an official Committee clearance, which I don't think we should consider now anyway. We might have to do it by telegram, but--

MR. GUFFEY. Is this shared with the Treasury?

CHAIRMAN VOLCKER. This would not be; I don't see any point. Theoretically it could be, but I don't see any point dragging them into it; I'd do it myself. And similarly, this drawing in November-December doesn't rest upon any Treasury participation, although it may be that they'd want to participate. Not hearing any objections expressed, we will use our judgment. If it gets above some nominal amount we would have to have an official Committee clearance anyway. But if it gets that far--not that we didn't want to see it [unintelligible]--we would send out telegrams.

SPEAKER(?). Aren't you going to get the approval?

CHAIRMAN VOLCKER. Yes, I think the one thing we do want to take official action on is just approving the basic bridge. I suppose we can approve it with an open-ended amount because it will be roughly 50-50, I think, with the Treasury. I just haven't worked that out with them precisely. It's not critical, but with that reservation as to precisely what the amount is, I suppose what we want to approve is suitable participation in an American bridge of $545 million under the terms and conditions that have been described. That I think we can take a vote on.

VICE CHAIRMAN CORRIGAN. I move it.

MS. SEGER. I'll second it.

CHAIRMAN VOLCKER. Is there any objection? If not, that official bridge is approved. I assume a sympathetic view toward the November matter--should it be recommended to you under the conditions that are described in this memorandum--and a certain degree of flexibility if it appears desirable to do a very short-term drawing at the end of August.

MR. KEEHN. What are the major terms and conditions on the commercial bank credit? And is that going to take a push and a shove to get across?

CHAIRMAN VOLCKER. Yes. There are several problems on that, starting with the fact that the estimates that were made on the size of the needed commercial bank financing were based upon assumptions of a $10-1/2 Mexican oil price this year and $11 next year. I emphasize Mexican oil price because about half of their exports are heavy crude for which the price is quite a lot lower than the prices that you see quoted. Their blended price rounds up to $3 less than, say, the west Texas [intermediate] price you see quoted in the papers because so much of it is heavy crude and there's a little transportation discount, too. Before this OPEC decision, when the oil price was at its low, the blended price of the oil they were selling was less than $9. Obviously, it has been substantially higher than that in the last couple of weeks. But on that assumption of $10-1/2 this year and $11 next year their gross reserves would rise by about or in that neighborhood, over this period. In fact, they would rise from the end of 1985 to the end of 1987 by about that would take them back roughly in the range, which is something the IMF insists upon. They always insist upon getting reserves back to some half-way adequate level. The bank financing need, given all the other assumptions about financing, comes out to about $6 billion net to the public sector. Now, that's a little misleading but that's a figure that gets quoted. Those figures assume repayment, net, of about [$1] billion by the private sector to the banks. So, if you look at total commercial bank exposure to Mexico, the assumption is that it will go up by about $5 billion; the $6 billion figure that gets talked about is the net exposure to the public sector. But in Baker-initiative terms that are talked about the total exposure to the country is $5 billion. Their total exposure now is $65 billion or something like that?

MR. TRUMAN. It's around $60 billion to the public sector and another $15 billion to the private sector.

CHAIRMAN VOLCKER. $75 billion? So if you think of it as a 2-year program for 1986-1987, which in some sense it is because the banks haven't been lending anything this year--they didn't lend anything last year, but forget about last year--that $5 billion increase in exposure is less than 3 percent a year. That is on the high side but within the parameters that were talked about in the Baker plan all along. If you look at the period as 15 months it comes out to a higher percentage, but I don't think that's quite fair because they haven't been lending anything so far this year. So it's broadly within the parameters of the Baker plan but it's also larger than we or the banks anticipated some months ago before the oil price took its last decline. And I'm sure the banks will argue that since the oil price is up again they will make a more optimistic estimate on the oil price and cut down the amount. So, that's issue number one: the amount.

Issue number two is the concept stated explicitly in the program with the IMF that if the oil price declines below the $9 Mexican price there would be additional financing from the IMF and, by implication, from the commercial banks too. That is symmetrical. If the price went up above $14--I think that was the number they had in there--there would be less financing. Actually, it's closer to the $14 level than to the $9 level if you took today's figure. But there was this contingency arrangement which some banks liked and other banks seemed to dislike intensely. Similarly, the Mexicans will certainly ask for a reduction or elimination of the spreads on the outstanding notes as a straight concession from the banks, maybe related to the oil price. That is, if the oil price is below a certain level reduce the spread; if it's above a certain level they repay it. They also want for presentational reasons--they think it's very important politically--to get an extra big concession on some portion of the new money which again, in their eyes, would be related to the oil price. That would be a big concession--

They haven't put these cards on the table yet, but in concept it would be something on the order of

I'm just picking numbers out of the air, but that is the concept. In fact, there was a bond issue sold in the market a few weeks ago by Standard Oil of Ohio, or whatever its name is now. Is it still Standard Oil of Ohio? It was precisely on that basis that it was sold in the public market. It had a rate of interest related to the oil price: a low rate of interest when the oil price was low and a high rate of interest when the oil price was high. And it was salable in the market. A lot of banks have said they object intensely to that as a matter of principle--that they are not in the business of making loans whose interest rates vary in accordance with some external indicator. They're in the business of making bank loans for other reasons. There will be a big conceptual fight about that. So, yes, it's going to be difficult. That is why I think Mr. Mancera probably has some skepticism about how quickly this could all be put together. In fact, I think it's not going to be fatal if the amount of the loan is cut back a bit. But it can't be cut back to $4 billion; that is out of the question; $5 billion with some contingency clauses, maybe. I don't want to give away the Mexican's negotiating position but I think something can be worked out on an amount that looks reasonable. But these terms on interest rates are going to involve very difficult negotiations; there's no doubt about it.

I think those are the principal issues, but I'm sure other issues will arise. What is unusual about this, in terms of past patterns, is the amount of official financing that's involved. Even with the commercial banks at $6 billion to the public sector or $5 billion overall, there will be somewhat more official financing than there will be commercial bank financing, which is unusual. This is a bridge, of course. But if you count the official financing calculated over the full time period of the program there's a lot of World Bank money and of course the IMF money and there is an intention of there being a Paris club which provides quite a lot of money. The Japanese have semi-promised some special project financing which could run as much as if you believe it. I don't think it'll be that big but it could be up to that. In terms of special bilateral financing to Mexico, there is CCC financing. I don't remember exactly what it all adds up to, net, but it's a little more than the private financings. Fortunately, the amount of World Bank money in any bilateral deal they do with Mexico is new.

VICE CHAIRMAN CORRIGAN. I sent out to the Reserve Bank Presidents on Friday--you probably didn't get it yet--all of the publicly available documents laying out the details of the overall financing plans: who's in for what and the rest of it. The other issue that comes up is this supervisory question, of course. Your senior supervisory people have a piece of paper that was agreed upon by the federal regulatory agencies that sets forth the policy statement as to the collective attitudes of the federal supervisory agencies on this whole reserve question. That piece of paper is not to be shared with the banks; it essentially says there's a lot of [unintelligible] but we look at these things on a case-by-case basis.

CHAIRMAN VOLCKER. I haven't looked at that for some time. I don't know if that's ever been officially adopted. When the banks get a little further on in this negotiation they may well press us for a written statement and I'm sure it will look something like this. But at this stage I don't think it should be given to them.

VICE CHAIRMAN CORRIGAN. No.

CHAIRMAN VOLCKER. It could well be that in two or three weeks we could have a joint statement by the regulators, which probably will incorporate this language, that could be published or sent to them.

MS. SEGER. Are you saying this is a new policy, Jerry? I missed something.

VICE CHAIRMAN CORRIGAN. It's not really a new policy, but it gets on paper a philosophy that had been agreed to by Messrs. Clark and Seidman and our people.

CHAIRMAN VOLCKER. We made a statement along these lines on one or two of these previous occasions, but it arises every time and the statement gets slightly edited every time. It's not entirely new, and it's not entirely a departure.

VICE CHAIRMAN CORRIGAN. It basically says all the customary things: the decisions are your own; the examiners by the nature of their work, of course, have a responsibility to look at these loans; they're going to focus primarily on your system's procedures, controls, etc.; and there is no automatic linkage between decisions, especially when they're in the context of an internationally supported program. They will be looked at case-by-case, taking account of the overall condition of the bank.

CHAIRMAN VOLCKER. Perhaps we can return to this subject later after the meeting, if you want. The usual complaints go to the Comptroller's Office. It follows a long technical procedure sometimes, but we are not exempt from such complaints. Somebody told me the other day that there was an actual letter of agreement with some bank in which part of the agreement was that the bank would under no conditions increase its exposure to less-developed countries. That letter was being used to say: How can we participate when we had such an agreement? I don't think the agreement was with our cease-and-desist people; I think it was with the Comptroller. I'm not sure.

MR. TRUMAN. It was.

CHAIRMAN VOLCKER. You have to be a little suspicious of these things. I can imagine that that bank invited the Comptroller to put that provision in the agreement.

MR. TRUMAN. We did check, Mr. Chairman, and in that particular case it was a general provision about working down the exposure to troubled debtors and that was as far as the letter went. The bank was choosing to apply this particular [interpretation].

CHAIRMAN VOLCKER. All right. Well, you have to be a little careful because banks will be very eager to apply--

MR. BOEHNE. In the past there has been a problem of very large banks accounting for 85 or 90 percent of the money and then we spend all our energy trying to get [the remaining] 10 percent by dealing with hundreds of regional-sized banks. In putting this package together, has any thought been given to where the money is coming from and how we're going to spend our labor in terms--

CHAIRMAN VOLCKER. Well, if you want to discuss this further I'd be happy to but I'm just worried about having the time in this meeting. We're going to have that problem again. Some of the major European banks, may insist in the end on doing this in the form of an interest-capitalization deal, and maybe if a very small margin of banks do it that way this all will come out. But that bridge has not begun to be crossed yet and I wouldn't breathe a word of that at this stage. It may be that something innovative will have to be done to pull in that last 10 or 15 percent, as you say. We can return to the supervisory aspects of this later so long as the Open Market Committee aspects are clear. Are there any other questions on that? If not, we'll turn to Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any questions or comments?

MR. WALLICH. You know that I have difficulty expressing myself, but I'd like to ask in this particular instance of either Mr. Sternlight or Mr. Kichline: Does the view of the people in this group lean more toward one force or another on this issue? I'm not trying to settle something difficult; I'm simply asking on the issue--

CHAIRMAN VOLCKER. The issue is what?

MR. WALLICH. The issue is where do you see the present view as you look at the business [outlook]?

CHAIRMAN VOLCKER. I think we'll get to that question a little later--the tendency of business and the tendency of open market operations. So maybe we can defer that question.

MR. WALLICH. Okay.

CHAIRMAN VOLCKER. Are there any other comments or questions? We do have to ratify transactions here, as always.

VICE CHAIRMAN CORRIGAN. So moved.

MR. ANGELL. Second.

CHAIRMAN VOLCKER. [Approved] without objection. The question has been asked from time-to-time--I confess mainly by me, and I don't want to take undue time on this question because it's not a matter of enormous urgency--as to why we purchase long-term securities occasionally. I wonder about it every time the issue arises. So I had some discussion about it with Mr. Sternlight and he prepared this little memorandum for you on the pros and cons of occasionally participating in the bond market, which in recent years we have done about twice a year. As I say, it's at rather odd times in a kind of arbitrary guise, and every time I wonder: Why now? What are we attempting to achieve or prove by buying some long-term bonds?

MR. RICE. I was going to ask Peter one question.

CHAIRMAN VOLCKER. Let me just make one other comment first. I have nothing philosophically against buying long-term bonds or coupon issues if they serve some purpose. I'm not arguing a "bills-only" doctrine at all. If we have some purpose we want to achieve by buying bonds, fine. The purpose is rather elusive in what we do now.

MR. JOHNSON. May I express a partial Treasury opinion from my past?

CHAIRMAN VOLCKER. Sure.

MR. JOHNSON. It was always thought that it would be nice for the Fed to get into long bonds because the Fed always rebates the interest and that saves on the interest the Treasury owes.

CHAIRMAN VOLCKER. It has a slight effect on the rate, depending on how much we do and how much we turn over to the Treasury. Of course, the counter argument to that is: If the Treasury doesn't like the cost of the long-term bonds why issue so many?

MR. JOHNSON. I agree with that. I was unsuccessful in discussing that.

CHAIRMAN VOLCKER. The other consideration, just to throw it in here, is simply emphasized in this memorandum. I'll point it out: These days it may seem a little wild to you but I do worry a bit about the liquidity of our portfolio, given the possible contingencies in the banking world. If we have to lend a lot of money--in tens of billions of dollars--suddenly to the commercial banking system we presumably would want to liquidate our portfolio to make up for that. Under most conditions it's extremely difficult to liquidate coupon issues anyway. And certainly, in those kinds of conditions it would be even more difficult. I would never want to be in the position where I felt that we had any degree of inhibition from liquidating securities because of the composition of our holdings. Now, it is also true that there is a constraint--what we have to have there in covering the note issues. We could get into a bind regardless of the liquidity of our portfolio by not having the types of assets which the law says we have to hold against our note issues. Certain types of discounted paper can be used but not the type that we ordinarily make these days. And maybe some day we ought to think about changing that law or changing our procedures or something, but that is an additional constraint apart from the liquidity of our portfolio. I have had these reservations from time-to-time and I thought it would be useful to have a discussion. Mr. Sternlight could you shed some light on the matter?

MR. STERNLIGHT. Thank you. You said some of what I would say in your introduction but the question naturally arises as to why this is on the agenda. The chief reason is that on some recent occasions when Desk operations were undertaken or contemplated basic questions were raised, as you mentioned, as to the need for or the desirability of those operations. In any event, it's probably a good idea to take a fresh look at subjects like this from time to time. [Statement--see Appendix.]

MR. RICE. Did you say you haven't done anything so far this year?

MR. STERNLIGHT. So far this year we have not.

MR. RICE. Any particular reason for that?

MR. STERNLIGHT. Well, as the Chairman mentioned, he has a discouraging word now and then. Typically, we have done it in periods of heavy reserve need--once in the spring, usually. Going back to something you said earlier, Mr. Chairman, I don't think the times are arbitrary. It has been done when there is a big reserve need, usually in April or sometimes in that heavy seasonal need around the year-end period. I guess the last time was actually early December '85.

CHAIRMAN VOLCKER. Well, the times are arbitrary only in the sense that there's no particular reason at those times to do coupon issues as opposed to something else. But it is clearly consistent with the reserve needs at the time. You don't do it right in the face of obvious reserve [reducing] indications.

MR. ANGELL. I think you've answered part of my question by indicating that you generally buy the traded security rather than at the auction.

CHAIRMAN VOLCKER. Yes.

MR. STERNLIGHT. Yes, at the auctions--

CHAIRMAN VOLCKER. We're talking about the [unintelligible].

MR. STERNLIGHT. At the auction we would only roll over the maturing amount. As I mentioned, a few years ago at an auction--particularly these big quarterly refundings, where there would be an option of going into any of three issues--we were dividing our holdings in about the proportion that the Treasury offered them to the public. But that was tending to lengthen our portfolio because the Treasury was putting its emphasis on offering more longer-term debt. In recent years we've tended to slant the mix more toward the shorter-term options, and in the last year we've tended to move even further in that direction of slanting our rollovers toward the shorter-term options.

MR. JOHNSON. Peter, I'm sorry, what [unintelligible]?

CHAIRMAN VOLCKER. Planning the rollovers relative to what the Treasury has been offering, which is more long-term securities.

MR. ANGELL. Yes, but when you've been buying, I presume you buy the actively traded issue.

MR. STERNLIGHT. Well, we buy depending on what's offered to us. There will be more offerings of the actively traded issues, but sometimes there will be an attractive offering of some less actively traded ones. And I think that probably tends to improve the market in some of those less active issues.

MR. ANGELL. So, by buying the less actively traded issues then you get a higher yield than you otherwise could get?

MR. STERNLIGHT. I think it often works that way, yes.

MR. ANGELL. I have some hesitation in seeing us buy the actively traded issues, then holding them when they become inactive, and taking what I would call a loss in liquidity that occurs when an active issue becomes inactive. But it's--

CHAIRMAN VOLCKER. When is the last time we sold a coupon issue or bond?

MR. STERNLIGHT. We sold some short-maturity agency issues a few years back. I don't think we've ever sold coupon issues.

CHAIRMAN VOLCKER. Basically when you buy a coupon issue you don't sell it.

MR. JOHNSON. What is the issue about liquidity here? What do we need the--

MR. STERNLIGHT. I think we want to be prepared. In 1984 when Continental was borrowing massively, we had to lighten the portfolio by several billions of dollars over a short period of time, and it was very useful to have ample supplies of Treasury bills to be able to do that.

CHAIRMAN VOLCKER. That's it. The liquidity issue [unintelligible].

MR. JOHNSON. $90 billion?

MR. STERNLIGHT. We have some $95 billion or so of bills now.

MR. ANGELL. It isn't always true that you can gain liquidity cheaper. Your give-up cost isn't always lower by selling bills; sometimes you can have a give-up cost that's lower selling coupons than selling bills. But you don't sell coupons.

MR. STERNLIGHT. We have not. I think it's a good question--whether we shouldn't develop that potential.

CHAIRMAN VOLCKER. We do so [unintelligible] because of the [unintelligible], which I think is correct. This probably goes back decades and decades. If the Federal Reserve were to walk into the market and sell bonds it would have a big impact on the market, particularly since we never do it.

MR. ANGELL. It seems to me that we ought not to be in coupon issues unless we have a policy of also selling coupon issues. That is, I would prefer that we manage the account in the same way that one might manage other kinds of accounts. I hesitate for us to be in coupons without fully playing both sides; I think if we're going to be in coupons we ought to have the alternative of selling coupons.

MR. STERNLIGHT. Well, there's a lot to be said for being able to develop some flexibility to sell coupon issues as well as bills.

MR. MORRIS. There might be times when the market would be supportive of a policy to sell some along the [unintelligible]. I think of October '79 when we had a 2 percentage point increase in the discount rate; that attracted a lot of attention. In a situation like that where we want a big response rapidly it seems to me that a relatively small sale of coupons issues could have a rather big impact. And there might be times when we want a big response.

MR. JOHNSON. I agree. I can see a time when a coupon sale would be useful.

MS. SEGER. Especially if we never do it!

CHAIRMAN VOLCKER. I can, too, theoretically. I would observe, or bet you, that in 40 years you can't find an occasion when we found a suitable time.

MR. JOHNSON. But that period that Frank described may have been a suitable time, I think. I don't know.

MR. STERNLIGHT. Rates were shooting up then.

CHAIRMAN VOLCKER. In retrospect, but--

MR. ANGELL. It seems to me "bills only" is a lack of flexibility. But coupons when you can only buy and can't sell is a lack of flexibility.

MR. STERNLIGHT. You can run them off too.

CHAIRMAN VOLCKER. Well, Peter, I find it difficult to see the circumstances. Theoretically, I can see circumstances in which we would sell. For instance, that October I at least sat here with some hopes that we would have such a dramatic effect on the market that in a few weeks long-term rates might decline. That shows you how naive I was at that time. The last thing I would have wanted to do was to sell long-term bonds.

MR. JOHNSON. [And drive up] the yield curve.

CHAIRMAN VOLCKER. Drive up the yield curve and oppose that hope--false hope as it turned out. Sure, theoretically, you might want to sell them at some times. I also would agree--I just want to make very clear--that I can see times much more practically when you might want to buy coupons. If we have a specific reason, I have nothing against it whatsoever. I would not want to give up that tool of being able to buy them. The question is whether we should routinely buy them.

MR. BOEHNE. It seems to me we have two different discussions here. One is that we might sell them in special circumstances. But

Wayne raises the point of why not condition the market in such a way that we can sell them routinely. And I think that's a more interesting question. What would be involved in, over time, trying to condition the market [to the view] that if the Federal Reserve sold coupon securities that it wouldn't produce an earthquake?

MR. STERNLIGHT. Well, probably some educational effort and starting out with shorter maturities. We did a little conditioning like that before we sold some short agency issues. And that was taken reasonably well. Of course, there are really not all that many occasions when we sell bills. The potential is there, but I think we've gone over a year now without selling a bill. The long-term trend is up.

MR. BOEHNE. But there seems to be merit at least in exploring how one might improve the liquidity by setting the stage for being able to sell these on a rather routine basis, at least as routinely as selling bills.

MR. JOHNSON. If we put out a press release that says we would sell Treasury securities in the same proportion that we buy them in these contingency situations, we could do that on a regular basis.

MR. ANGELL. If you put out such a release, the bond markets are going to be immediately affected by that release. And you probably are not going to want to have that impact.

CHAIRMAN VOLCKER. You're right. That's why we haven't sold any.

MS. SEGER. Have you sounded out many primary dealers on this matter?

MR. STERNLIGHT. On the selling of coupons, or--?

MS. SEGER. Well, both sides: being in the coupon market period, as a buyer or a seller.

MR. STERNLIGHT. Sometimes they will bring up the matter, saying "You haven't been around recently to buy coupon issues," or something of that fashion. I have not raised it.

MR. ANGELL. If we put out a release and said that we're going to buy more coupons and we're going to sell more we might get by with doing that and not affect the market. Yes.

MR. JOHNSON. That was the point I was getting at: talking symmetrically about buying in the same proportion that we sell, along the lines that since we've been cutting back on the proportion of the Treasury's issues--. I think that would balance the market; maybe not.

CHAIRMAN VOLCKER. I would be--

VICE CHAIRMAN CORRIGAN. In order to be able to do that I think you'd have to get to the point where you're pretty active.

CHAIRMAN VOLCKER. And what's the point of being so active in the market?

MR. JOHNSON. Well, I agree with that. I'm not for changing just for the heck of it.

MS. SEGER. What would your maturities be in an average week? I can see what your total bill holdings are, but when you're talking about being prepared for the failure of XYZ bank in short order--. Without selling, I would suspect that you have some sort of laddering in your portfolio that each week you must have bills maturing and also--maybe not every week but fairly often--some of your existing coupons coming due.

MR. STERNLIGHT. There are a lot of coupons due within a year that mature every month or every--

CHAIRMAN VOLCKER. With maturing coupon issues, the pressure is always to roll those over so the Treasury isn't pressed with the bigger job of placing them in the public market. I don't know. Have we even let a coupon [run off]?

MR. STERNLIGHT. I think we pretty generally have rolled over coupon issues. It would be a complicated thing to work out. In the case of bills, Mr. Chairman, if we run some off--which is a reasonably common occurrence--then the Treasury automatically announces that they're selling X billion so that the market will pick up more. But when they announce their coupon offering, what they offer to the Fed is separate from what they offer to the public. If we ran some off it would, at least under current procedures, hit them as a cash loss.

VICE CHAIRMAN CORRIGAN. Well, I look at this thing rather simplistically. It is arbitrary, but I kind of like what we're doing and that is maintaining what I at least envision as something close to a minimal level of presence in the coupon market. From my perspective, that's fine. I don't think we can reasonably embark upon any ambitious program of working on both sides of that market without some very, very basic changes in the whole approach to open market operations. But both for contingency reasons of a slightly different nature and just to maintain that point of contact with the market, I think showing ourselves--even if it's only on the buy side a couple times a year--makes some sense.

MR. ANGELL. I would like to see the weighted average maturity over time. The data we have doesn't give us that. It would be very helpful to have a history of the weighted average maturity.

MR. STERNLIGHT. I could provide that, certainly.

CHAIRMAN VOLCKER. You can provide that, obviously, but the weighted average is not what you're selling. You sell the very short stuff that you have; whether you have a 10-year bond or a 30-year bond doesn't make much difference. You're not going to sell either one. That is the argument that's made. I don't understand it, frankly, because I don't see what purpose is served by it.

MR. BOEHNE. [Unintelligible.]

CHAIRMAN VOLCKER. That is the issue, I guess. I don't understand it, but that seems to be the issue.

MR. GUFFEY. I guess I've always been--

VICE CHAIRMAN CORRIGAN. [Unintelligible] a heck of a contingency to it. Just as you can envision a set of circumstances where you might think it desirable for some policy reasons to be selling bonds, it's hard to conjure up when to do it. I think it's a little easier from a policy perspective to conjure up a situation where it might make sense to be buying.

CHAIRMAN VOLCKER. I have no difficulty in conjuring up a policy where you want to buy; I have no problem--

VICE CHAIRMAN CORRIGAN. But if you want to have policy flexibility, it does seem to me to be marginally advantageous to maintain some presence in the market so that when you want to do that you don't produce the very splash effect that prevents you right now from selling.

CHAIRMAN VOLCKER. My difficulty then is you get a policy reason for what--to buy bonds [if] you want to make a splash?

VICE CHAIRMAN CORRIGAN. Maybe; in which case the argument is moot. But it may not be that clear that you want to make a splash.

CHAIRMAN VOLCKER. So far the liquidity argument is one [against] the central bank holding any long-term securities. But on the liquidity issue, obviously, we've been buying so much in the past year that Treasury bill holdings look more adequate now than they did two or three years ago. All you have to do is [consider] two or three years ago putting Continental together with--all apologies to the present company-- and a few Texas banks and you've got a big liquidity need rather suddenly.

MR. JOHNSON. I'd forbid that coincidence!

MR. BLACK. I think that's a more important point, Mr. Chairman. You touched on it a while ago about the collateral cover for Federal Reserve notes. It'd be sort of ironic if the collateral cover, which was designed to make them safer and presume there's a limit to the issuance of money, led to an overabundance of demand deposit money because we didn't have the free securities to sell to sop up the reserves injected by borrowing. So, if there's an opportune time, I think we might well want to consider lowering the gold certificate requirements and then eventually eliminate them because that's getting pretty close now.

CHAIRMAN VOLCKER. All these sins we've made in the past--eliminating all these safeguards that were in the law--we can now make another one.

MR. BLACK. They never really had any any effect on limiting any of those things. But to me the argument that Peter makes is most persuasive. And also, it gives him a chance to keep up with what's going on in the market. That's the most persuasive argument. So, I'd opt for staying where we are, but I don't think it's any big deal one way or another. We're increasing liquidity all the time because he's not buying enough [bonds] to lower our liquidity. So if liquidity is getting better it's not really a big issue.

CHAIRMAN VOLCKER. This is not a big issue; it comes up from time to time. But if we continue buying I would [unintelligible] and do rollovers into much shorter issues. That's the alternative. There's some value in buying [but] we pick up liquidity by doing rollovers into much shorter issues. I don't see the value in buying.

MR. BLACK. Yes. It's interesting to have someone who has been at the Board and also at the New York Bank with the other view--someone who has been both places looking at this "bills only" issue.

CHAIRMAN VOLCKER. I am not for "bills only"; I'm perfectly ready to buy long-term bonds if there's a purpose in buying long-term bonds. But I have a little difficulty being willing to buy them when there is no purpose in buying them.

MR. BLACK. You occupy a unique position having been in the two prime places when these different arguments have been made in the past.

MR. MELZER. If you stop buying long coupons right now though, it will be very visible, it seems to me. If you did a coupon pass and didn't touch long coupons, I think somebody would try to read something in there with respect to inflationary expectations or whatever. So we're better off not to do a coupon pass at all.

CHAIRMAN VOLCKER. Well, we haven't done any for the last three months when we ordinarily might have. Presumably, if there is an ample supply of bills we just wouldn't do the coupons at all.

MR. GUFFEY. Well, we did pass this spring, which would normally have been a time for a coupon purchase, right?

MR. STERNLIGHT. Yes.

MR. GUFFEY. For a reason?

MR. STERNLIGHT. I think the Chairman had reservations about dealing in this market.

CHAIRMAN VOLCKER. The reason was that we had scheduled this discussion and decided this was the first meeting in which the agenda wasn't cluttered with other things.

MR. STERNLIGHT. And there may have been times when we would pass a period just because at the time we had the reserve need the market was under this or that special influence that we didn't want to be in the--

CHAIRMAN VOLCKER. It hasn't been that rigid, anyway. We've only done this twice a year. Well, I don't think it's worth a lot more discussion right now. We can continue what we're doing and let it just fade for a month and reach a concrete decision next month or reach a decision now. Do you want to let this matter gestate a month or do you want to reach a decision?

MR. ANGELL. Gestate.

SPEAKER(?). [Unintelligible] just this month.

CHAIRMAN VOLCKER. Well, why don't we come back and make a firm decision on this less-than-overwhelming matter next month?

MR. KICHLINE. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Comments or questions?

MR. PARRY. Jim, do you have those numbers for inventories and net exports in the second quarter in real terms?

MR. KICHLINE. In dollars?

MR. PARRY. Dollars.

MR. KICHLINE. The change in business inventories of minus $28.3 billion had been minus $20.3 billion. So it's a large downward revision of $8 billion in real terms. Half of it is in farm inventories; half of it is in nonfarm. Net exports now show a change of minus $24.6 billion compared to minus $20.4, so that's a decline of $4.2 billion.

MR. BLACK. Jim, do you have private domestic final purchases in percentage terms?

MR. KICHLINE. I have gross domestic purchases here.

MR. BLACK. What would that be?

MR. KICHLINE. They had been 3.2 percent and are still 3.2 percent. Final sales were actually revised up, obviously, in this situation. They had been reported at a 3.4 percent increase and they are now at a 3.8 percent increase.

MR. PARRY. That change in inventories from the first to the second quarter is very substantial. I don't recall exactly what you have for the third quarter, but does that raise the possibility in your mind that we actually could get more growth in the third quarter as inventories perhaps come back into better alignment with what activity is?

MR. KICHLINE. Well, there are a couple of things about this number. First of all, under the new procedures [the Commerce Department] releases details tomorrow. So, we don't have the details.

MR. PARRY. We don't know--

MR. KICHLINE. Part of the farm [story], I think, may be the CCC because government purchases were revised up. So the question is really on the nonfarm side. From the little information that we have around, it appears that it's a revision in part in the deflator--a higher deflator and thus lower real expenditures. The question is: Is it in oil or is it something else--perhaps merchandise trade? We don't know. In our view, we have a further runoff in the third quarter, which is mainly in autos. Outside of autos our forecast entails something flat. In fact, supporting your supposition, we have very strong consumer spending in our forecast, as I mentioned, and we don't have much in the way of production. The question is: Is it going to come out of inventories or are we going to have more imports or are we going to have rising production? It's a question. Essentially, given these data along with what was happening, one can argue more strongly that expansion in demand is going to lead directly into production because inventories in most sectors, outside of autos, are very lean.

MR. PARRY. Yes.

MR. MELZER. I was going to make a comment along those lines because as I looked at your numbers--with personal consumption going from 1.7 percent in the fourth quarter of last year and then to 3.6 percent [in the first quarter] and 5.9 percent in the second quarter and employment growth and personal income growth and so forth seemingly staying pretty much on track, at least over the course of this year--one really has to question the dropping down of personal consumption to the 2.4, 2.5 percent level, looking forward. You actually raised those same questions in your comments already, so I don't want to elaborate on it. But it seems to me in looking at this, one could say that there was some uncertainty in that direction in the forecast.

CHAIRMAN VOLCKER. Let me ask a question which often arises anyway and I think it was what Governor Wallich had in mind: In assessing the overall tenor of this forecast, are the forces in the direction of sustained expansion or hesitancy?

MR. KICHLINE. Well, the forecast--

CHAIRMAN VOLCKER. Where do the risks lie?

MR. KICHLINE. The forecast, I think, is reasonably balanced. There are risks on both sides of this and I wouldn't say they are skewed in any significant way. Obviously, we have a forecast that shows improvement over time. Some of the risks have been talked about, certainly [at the FOMC meeting] in July. On the down side, for example, one of the risks relates to what's going to happen to the trade sector; it's clearly a key in this forecast. And that raises questions about foreign growth and demands for our own exports. One of the downside risks is in business fixed investment. Frankly, in the office and commercial area it now seems that both commitments and structures are going down at a tremendous rate. That sector could be one for which we perhaps have underestimated the severity of the decline. On the other side, I'd say we do have a slackening in growth of consumer spending that we think is consistent with what's happening to disposable income. There's just no question, if you look at the data, that consumers have been quite willing to spend and [unintelligible] generated enough income in this forecast, it seems to me, that consumer spending at the rate we have could look very moderate. So, there are risks on both sides, and I think it's rather reasonably balanced at the moment.

CHAIRMAN VOLCKER. The forecast, as you have mentioned several times, is heavily dependent upon a rather strong improvement in the foreign trade balance in real terms, not necessarily in monetary terms. It may be worth having Mr. Truman justify the forecast.

MR. TRUMAN. I should say that the GNP numbers that were put out, which show some downward revisions on the export side and an upward revision in real terms on the import side, were in line with what we had guessed--based upon the preliminary numbers on the trade side that are still not available [in final form] for the second quarter. So, although the revision was downward on the overall situation, both components of it are consistent with how we have been reading the incoming numbers. The forecast for the external sector is basically contingent upon two factors. One relates to the exchange rate effects, which have been slow so far in coming. They have not yet come through in terms of showing much effect on slowing the growth of non-oil imports or speeding the growth in the volume of nonagricultural exports. [We believe] that we will in due course begin to see those effects; and the anecdotal information, from what I have seen, is consistent with that. We're now getting some stories of firms moving from the category of "we're eager to compete" to "we're beginning to get some orders in the fall" from that. The other important factor is that we are assuming that the lull in growth in the first quarter in other major industrial countries, at least as far as Europe is concerned, will be replaced by faster, though not exuberant, growth over the next six quarters. A third factor, which we may not have taken into account quite as much, is that in the last several quarters with the Mexican situation we have lost exports and increased imports because they have moved [down] their exchange rate over the past year against the dollar; the rate had gotten out of line again, essentially since July of 1985. They also have lost income. The two things together have had an impact on our trade with Mexico, which is one [unintelligible], if anything, we should at least be reducing in emphasis.

CHAIRMAN VOLCKER. Maybe it would be worthwhile getting any comments Committee members may have at this particular point on the external prospects.

MR. HELLER. Well, I think it would be very nice if the forecast came true, but I'm pretty pessimistic. [I doubt] that we are going to see [export] growth rates of up to 15-1/2 percent on a quarterly basis. Certainly, in Europe and Japan it's going to be very tough for Americans to make rapid inroads into those domestic markets. And at the going exchange rates, I don't think we really have a competitive advantage, although we have roughly leveled the playing field versus other industrialized countries. I don't see the growth in the LDCs--and I think that's where the relative exchange rate movement probably has a bigger role to play, because when you're competing in [third] markets you're on more equal terms than when you're competing in foreign home markets--in spite of the generosity as far as Mexico is concerned. The federal deficit, I think, plays a role too. And that certainly isn't going to come down as fast as the trade balance comes down [in your forecast], from $146 billion to $82 billion at the end of the forecast period. That's a terrific swing. My last question to you really would be: What do you assume as far as exchange rates are concerned to make that scenario compute?

MR. TRUMAN. We're assuming a further moderate decline, at least on the scale that we've seen over the past 17 months or so now.

So, the dollar declines at roughly a 10 percent annual rate through the end of the forecast period. Given the lags in these relationships, though, most of that decline will not affect the nominal value of the trade balance; in fact, we even have [forecast] an adverse affect on it. As a consequence of that--you're quoting GNP numbers I guess--the trade balance [deficit] itself goes from the $150 billion range where we are now to only about $130 billion in the fourth quarter of 1987, just--

CHAIRMAN VOLCKER. This gets confusing. Now, what--

MR. JOHNSON. I think you're quoting--

MR. TRUMAN. The $82-1/2 billion that Governor Heller quoted.

MR. HELLER. Net exports.

MR. TRUMAN. Net exports on a real basis.

MR. HELLER. Right.

SPEAKER(?). In the fourth quarter of 1987.

CHAIRMAN VOLCKER. You get a big difference between the real figures and the nominal figures, which gets very confusing. But a real increase in exports is still there in the forecast unless, assuming the question--

MR. PARRY. As I'm sure you know, there's a lot of port activity on the West Coast and the--

CHAIRMAN VOLCKER. A lot of what activity?

MR. PARRY. Port activity on the West Coast. The international trade picture there is very mixed. The public figures on port activity really don't provide much of an indication of a turnaround in the net export picture. But having said that, we certainly have picked up information that there are several key products where the situation has changed rather dramatically. There are larger exports of such things as citrus and almonds, particularly to the Far East. Wine is doing quite well and, just looking at it from the net export position, there has been a very substantial decline in imports again. Wood pulp is up significantly as well as seafood. So there seems to be some change but it's more anecdotal at this point and hasn't shown up in the port [activity figures].

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. I have just a little different impression, Mr. Chairman, on the trade front. Some of the retailers that I've talked to recently have been reporting some price increases of goods. It's still very spotty, but it does seem to be appearing more and more in autos and apparel. It doesn't seem to be getting through to the manufacturers, and the reasons that I hear for this are: first of all, that the quality of the goods coming in from abroad is very, very good and highly competitive with U.S. goods; and secondly, that some customer loyalty to some of these products apparently has been developing. It's hard for me to believe that price is not going to be an important ingredient down the line, but at the moment the price increases have not yet overcome the tendency of the purchaser to buy what he is used to buying given that he's also getting a good quality product. The other thing that I'm hearing a lot is that the improvement in the dollar vis-a-vis our trading partners, because it has been confined to the European currencies and to the yen, has not really helped a lot of industries in the Southeast. I've reported this before. This is particularly true with respect to Canada and to the east Asian countries such as South Korea. So we're not seeing in the Southeast any particular improvement in the trade sector yet.

MR. BOEHNE. The same is true in the Mid-Atlantic states. You hear some anecdotal evidence here and there that suggests that perhaps there are a few more orders. But there's a great deal of skepticism that any kind of a major turnaround in the trade sector is going to occur. In addition to the arguments that have already been given, the market share argument keeps coming up: that with unemployment high in European countries, it's just very difficult to lose those markets even with thinner margins. So we don't see anything that would lead us to share the kind of optimism that's implicit in the forecast.

MS. HORN. An argument we hear in our area that would put us on the side of not being very optimistic is that a lot of our manufacturers are conducting trade with countries with an exchange rate that hasn't moved very much. We hear that time and time again.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. One of the problems, Mr. Chairman, is that the lags are so long that I, too, am a little pessimistic about our ability to turn the situation around. I looked at the last two periods of decline in the dollar since 1970 and in those two periods the lag before we got a substantial change in net exports, apart from a bottoming out process, was 7 to 8 quarters. If we get this kind of sequence again, that means that we shouldn't expect to see much before the fourth quarter of this year or perhaps not even until the first quarter of next year--unless something in this cycle is going to shorten the lags. And I suspect that's not going to be the case. The lags are long and I think we have to be a little patient.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I think we not only have the normal J-curve effects here, but we also have to look at this in terms of the deflationary environment. That is, the J-curve effects in an inflationary environment could be quite different than in a deflationary one. We've already seen the impact of oil prices in terms of wanting to hold inventories during a period of declining prices. And we've now gone through a period with declining agricultural prices because of a U.S. policy change. We're now seeing a period of falling agricultural prices with a huge feed-grain crop, corn crop, coming on this fall. You tend in those circumstances to expect to find people delaying their purchases because they expect prices to be lower; so inventories will tend to be drawn down. I think our agricultural exports are probably not going to be picking up very much very soon.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. I'd just add to this a little. I agree that consumption seems to be doing quite well, but I think that we're probably putting too much emphasis on the G-10 trade-weighted dollar for the reasons that already have been mentioned. We're doing quite a bit of trade with a lot of countries whose currencies are still depreciating relative to the dollar; Canada and Mexico, our border countries, are good examples of that. It's not unreasonable to expect to see a continuation--well, there may not be a deterioration in our imports but, of course, if oil prices bounce back up a little we may see a further deterioration in imports. And with all the relative weakness in European and Japanese demand we're certainly not going to see improvement on the export side of the market. It is very difficult for me to see where this domestic production is going to come from. I still think that we're probably overestimating the impact of the trade-weighted dollar against the G-10 countries. I think that's the problem.

MR. TRUMAN. Well, in fact, we have tried to make an allowance for that in the forecast. That's one of the reasons why we have not gone with traditional model estimates as our basic forecast; we adjusted the G-10 [index] in putting the forecast together. I might add that I have a table here of our forecast and 8 other forecasts of the current account for 1987 and of the 9 forecasts listed on this table we have the largest deficit at $135 billion; the lowest is $98 billion. Now, there are price and quantity effects involved; so we may be too pessimistic on the price side and too optimistic on the quantity side. The two together, in any case, would produce for us a much higher current account deficit than anybody else who is represented in this listing.

MR. GUFFEY. From our perspective in the heartland, there has been some encouragement taken from the recent legislation for export subsidies of farm products--farm exports being a very big component part of our exports. I guess my question to Ted would be: Have you factored in the result of that subsidy program?

MR. TRUMAN. We have. We had built in a drop in exports of the agricultural sector in the first and second quarters in anticipation of that program. That is one basis for the modest increase we have, which is on the order of $2 or $3 billion in 1982 dollars, in our agricultural exports over the period.

MR. KEEHN. I have a fairly specific comment, but one that relates to heavy manufacturing. I had an opportunity a couple of weeks ago to visit with I think that reasonably describes the company. Their principal market, of course, is He observes that that's an industry that has a very, very significant worldwide overcapacity. Gradually, the business of the manufacture of has been coming under foreign control; as you know, within the last week there has been a further development on that. As a consequence, they just haven't had any benefit at all from the change in the value of the dollar and they say that the pricing in the market is just absolutely fierce. They finally, and maybe belatedly, have come to the conclusion that they just can't compete [unintelligible]. And they're going to begin to move a greater percentage of their production offshore as a way of trying to maintain their position. They just concluded that they can't compete when they manufacture domestically and that they're going to make a change. These [changes] tend to be fairly permanent. But it's the only way they see that they can remain viable in a very tough market.

MR. JOHNSON. May I ask a question? I heard a story the other day that there's a massive shift in demand into Canada for U.S. autos--General Motors and Ford-type automobiles--and that they're having to put sanctions on the dealerships in Canada to keep the flow of traffic from going over the border, given the exchange rate shift, to buy automobiles. I don't know if that's affecting the domestic sales level any, but have you heard anything like that?

SPEAKER(?). No.

MR. TRUMAN. I heard that same report. They were talking about something like $3,000 on a--

MR. JOHNSON. Yes, a huge [difference].

MR. TRUMAN. The report said that a car you could buy for $12,000 here you could buy for $9,000 in Canada, which was something like a 25 percent markup here. The Canadian dollar has not depreciated 25 percent.

MR. JOHNSON. Yes, it doesn't--

MR. TRUMAN. So, it sounds like they started out with a differential pricing policy that has come home to haunt them. It seems to me a segment of the market--

MR. JOHNSON. I couldn't tell if that was the case or not, but it sounded like they were inundated with U.S. crossovers and I just wondered--

MR. BLACK. Are these American cars?

MR. JOHNSON. Yes.

MR. TRUMAN. There was a joint agreement so that the trading, at least at the dealer level or the manufacturing level, is free between both parts and cars.

CHAIRMAN VOLCKER. It's not clear if some manufacturers export the cars up to Canada and import them back down or--

MR. JOHNSON. Well, I don't know if manufacturer--

MR. TRUMAN. Then they resell them in both markets; they are sold in both markets and they have different prices, not just a lower price in Canada. So, a large number now have sanctions.

CHAIRMAN VOLCKER. Governor Seger.

MS. SEGER. I wasn't going to comment on this, but since it involves going back and forth to Canada, people from Detroit understand all this because they've gone back and forth to buy gasoline when it was cheaper there than back in Michigan and the same [is true] with automobiles. They really watch this very carefully; they run over [the border] for meals, etc. So I'm sure they psyched it out.

I just want to report on some empirical research I did a couple of weeks ago by strolling through some local department stores and appliance stores. When you do that you see a lot of merchandise, at least in women's clothing, say, that is from Korea, Hong Kong, Taiwan, and even China. So, again, I think that looking at the typical series we look at for the weighted-average value of the dollar is just not that illuminating because the currencies of these countries have not appreciated against the dollar. So there hasn't been a big advantage for us here. In appliances, I was stunned to find the inflow from Korea. I used to think it was the Japanese that were providing all these TVs and so forth, but the Koreans are sending in a lot. Also, I saw quite a bit from Taiwan. So, I don't think that we're going to get a lot of consolation from this particular distribution of imports. And, in talking with a lot of industrialists whose main competition comes from Canada, they are not getting good vibes at all. The Canadian dollar is continuing weak relative to the American dollar.

MR. TRUMAN. Their trade deficit is beginning to increase. Their trade surplus is declining; the current account is increasing.

CHAIRMAN VOLCKER. Let me defend the weighted-average calculation, for what it's worth. The theory about these countries is that sure, the Korean currency, say, may not change but their balance of payments won't change either. And they now have an enormous incentive to divert some exports to Europe and Japan instead of to the United States and to buy more in the United States relative to what they buy in Japan and Europe. Now, it may [not] work out so neatly, but that's the theory.

MS. SEGER. Yes, but if you're talking to someone from Bob Forrestal's area or some Senator from South Carolina, I think that these kinds of relationships are significant because they have a lot to do with protectionist sentiment, even though it all may come out in the wash.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. First, I would follow up on a comment that Roger Guffey made. I think there are a few flickers of optimism, particularly among the wheat producers in our District. And that was true even before the export subsidy program was announced, [unintelligible] more price controlled. But beyond that, I would say that we are seeing some sustained and probably growing protectionist sentiment in the District. There's no other way to describe it. Also, I'd like to follow up on something Governor Heller mentioned and I hope this isn't an extraneous question: Jim, you do have a very significant narrowing of the budget deficit next fiscal year and it's not clear to me how much of that is due to Gramm-Rudman or other overt steps to reduce the deficit and how much is based simply on readings of the current services budget as it now exists.

MR. KICHLINE. Our current fiscal year 1986 budget deficit is $225 billion and we have it going down to a little under $170 billion, to $167 billion. Included in those numbers is essentially $45 billion of explicit deficit-reducing actions, $9 billion of which already have been enacted in a reconciliation bill so that $36 billion remains to be done at this point. That was our reading of a combination of what would be done in the budget process in reaction to Gramm-Rudman as well as revenues from tax reform. We had assumed about $15 billion on tax reform; now the estimate, if it goes through as currently planned, is that there would be a revenue increase of about $11 billion. So we're a little too high on those revenue increases. The rest would represent economic growth. Basically, the answer to your question is: [deficit reduction] in the $35 to $40 billion area, with explicit actions that would need to be taken to be consistent with the forecast.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. Yes, I'd like to return to the trade issue a minute. Clearly, the lags are very long in terms of improvement. I really don't have great difficulty with where the Board staff's forecast ends up at the end of 1987. We're slightly more pessimistic, but not much more. It would seem to me important for those who are negative to quantify how much they are negative. If they don't see improvement, then I think that turns what might be an acceptable economic performance in 1987 into something that clearly is unacceptable. So, I'd like to know what the degree of pessimism is here on the part of those who are not optimistic.

CHAIRMAN VOLCKER. Are you pessimistic, Mr. Corrigan?

VICE CHAIRMAN CORRIGAN. I was going to say partly what Bob just said. If we don't get an improvement in the trade balance along the general lines of the forecast the outlook [for the domestic economy] does go from something that is marginally acceptable to something that's pretty anemic. Having said that, the further irony of the situation, though, is that to the extent that you try and fix that up--at least through monetary policy--you run the risk of aggravating the trade side of it in the short run, aggravating the very problem that you're trying to solve. It's very hard when you go through the numbers--by country, by product, by anything you can think of--to see exactly where the improvement is going to come. Frank, I too looked at that '77, '78, '79 experience in terms of the dollar. And that says to me, if anything, that the lags will be longer, not shorter, for two reasons: (1) the level of the dollar was much higher to begin with so that there's more profit margin cushion on the part of the foreign exporters; and (2) the patterns of economic growth in that period from late '77 to early '79 were generally more robust on a world-wide basis. The difference between the growth in domestic demand in the United States vis-a-vis the other industrialized countries today versus then is really very sharp. That too says, if anything, that the lags probably will be longer.

I find this discussion about autos fascinating because I have a great deal of difficulty understanding how we're going to solve even the auto problem when, in the face of very sharp rises in import prices, domestic producers now are slipping in what strike me as very substantial increases in domestic automobile prices. This latest round of Chrysler price increases of 6-1/2 to 7 percent across the model line strikes me as astonishing in the current environment. The other point I would make, simply because it has been raised, is that I think the implications of this tax bill are a crap-shoot in terms of the near-term implications for the economy. I don't know, Jim, if you have any views on that, but it just strikes me as so incredibly complex that I am very hard pressed to have a judgment as to the net effect of it over the next 5 or 6 quarters.

MR. KICHLINE. Well, for what it's worth, what we have in the forecast is a negative impact, principally in the business fixed investment area and in multi-family housing. We have felt that the uncertainty of the current environment may be depressing spending and that passage and clarification of the rules might lead, at the margin, to some increase. But, on balance, we view it as a net negative feature of the forecast.

VICE CHAIRMAN CORRIGAN. I can't quite shake myself from believing, even though people tell me not to believe it, that at least the near-term effects of it could very well be inflationary. I don't see how you can shift as much tax burden to the business side without expecting that some, or perhaps a lot, of that is going to be fed through on the price side. And those higher prices are going to be financed by the personal tax cuts.

MR. BLACK. Well, phasing out the deduction of consumer loans over time should speed up some consumer expenditures now.

VICE CHAIRMAN CORRIGAN. I don't know.

MR. BLACK. I would think.

MR. MELZER. Also, the elimination of the deductibility of sales taxes has been cited in that connection. Make your big ticket purchases this year because you can't--

MR. BLACK. Right. Yes, that's another good point.

MR. MORRIS. I feel that the tax change is so comprehensive that we're just going to have to play it by ear. I don't think we have any idea what the effect will be. Given all of the interactions in this bill and the dramatic changes, I don't think we're in any position to forecast what the effect is going to be on investment, on consumption, or on anything else. I think it's just beyond us. It's one thing to have an incremental change in one tax, but it's quite another to have a wholesale revision of the whole system. It seems to me it's just unpredictable.

MR. JOHNSON. Yes. Speaking from [the perspective of] somebody who tried to do that for about 2 or 3 years while we were working on it, it is too complex, definitely.

MR. MORRIS. I've had a number of businessmen tell me that they think just resolving the tax issue and eliminating the uncertainty as to how investment is going to be taxed is going to exert some stimulus on investment, including multi-family investment. A guy who is running a lot of tax shelters says his firm is regearing and is going to start building projects on an economic basis.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. ANGELL. Does that mean that vacancy rates will once again enter into the picture?

CHAIRMAN VOLCKER. It means they won't build anything.

MR. MORRIS. They'll build in areas where the vacancy rate is still lower.

CHAIRMAN VOLCKER. Well, I think we probably are getting off just this external side. Let's wind this up with any comments anybody has about the business outlook generally. Mr. Wallace, do you have something?

MR. WALLACE. Mr. Chairman, I want to raise a question with Jim about his forecast that is unrelated to the trade issue. Jim, you've mentioned that your forecast is based on an assumption of a $16 oil price by early 1987. Are you assuming that there will be stability at that level and that that will be reflected in economic activity in 1987--that is, increased exploration and drilling and so on? Our people, for example, feel that there's going to be some considerable lag before an increased oil price is really going to be felt in the economy.

MR. KICHLINE. I think the path that we've assumed is something like $11 this quarter, $14 in the fourth quarter, and then $16 in [early 1987]. The $16 thereafter is, in part, ignorance; we've just assumed stability at around $16. What that does on the price side for petroleum products is that in the fourth quarter we'll begin seeing some price increases and under that scenario in the first quarter and in the spring they should be fairly large. Then it sort of flattens out. Outside of oil prices, in other service fuels, electricity and natural gas, that sort of thing, we think prices will continue to drift down; they've been laggards in this process. On activity, we ended up essentially suggesting that by the fourth quarter the halt in the decline in petroleum drilling will stop. And by the second half of next year we've added several billion dollars in increased activity. We may have it wrong, but the main story is that the decline stops sometime around now and we're just going to see small increases in 1986, but probably more later on.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. To continue along the line of inflation, Jim, your forecast for the fourth quarter of 1986 shows a fairly significant drop in the inflation rate from the third quarter. I know most model forecasts are monotonic and I wonder if you had something in there that is special that we should note since the price level in your forecast is probably a lot lower than a lot of other people have.

MR. KICHLINE. This is the fourth quarter of 1986?

MR. PARRY. Yes. The deflator goes from 2.5 percent to 2 percent and that's not usually what happens in a model forecast.

MR. KICHLINE. No, this isn't a model forecast.

MR. PARRY. Okay.

MR. KICHLINE. I think what happens is the initial perverse effects of higher oil prices; oil imports coming in at a higher price are subtracted out, which affects the fourth quarter.

MR. PARRY. Okay.

MR. KICHLINE. In effect, it's the arithmetic of GNP accounting in the deflator in that quarter when oil prices are rising.

MR. PARRY. So the domestic deflator probably would show this continuing increase.

MR. KICHLINE. It would show higher prices, right.

MR. PARRY. Okay, thanks.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I would just make a general observation. We've talked a lot about the dependence of this forecast on the foreign trade side and the substantial improvement there. But it seems to me that in some sense this is a reasonably conservative forecast even when you make that observation. As I look at what's in the forecast for consumption, for government spending at the federal level, for residential construction perhaps, and for durable equipment, it seems to me that those are all relatively conservative outlooks. I can certainly imagine without much difficulty that one or more of those components may do somewhat better than this forecast embodies. So, even if we don't get the material improvement in the trade picture that we're talking about, or if it's slower to come, or whatever, I'm not sure that that jeopardizes the forecast to such an extent that the outlook next year becomes unacceptable, at least to me.

CHAIRMAN VOLCKER. Anybody else have any general comments?

MR. JOHNSON. One last comment to follow up on Bob Parry's question. I'm not sure I can think far enough ahead to 1987; I'm more concerned about the rest of 1986. I'm not that pessimistic regarding the trade side except that my major pessimism lies in the area of growth in the industrialized countries. It appears that Germany may be on a better track now, but I'd like to see those numbers in detail before I'm convinced that they're going to do better than 2 percent growth this year. And Japan doesn't look like it's going to be improving. So I just don't see the pickup there. I think that Japan is at the beginning of a long transition process and that we're probably not going to see them improve dramatically for some time. I may be wrong about that but it appears to me that they are not going to be making any major contribution to export demands. The rest of Europe doesn't impress me all that much, but I'm hopeful that Germany is starting to pick up. A lot of my opinion about 1987 and the rest of 1986 will depend on how solid this German growth is, but I'm not particularly excited. I think we're doing reasonably well domestically but so much is being affected by the trade side.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, we come out about where I think Gary Stern came out in saying that the staff's forecast is probably pretty reasonable. Like most people around the table, we think that this J-curve is going to be a little lazier J-curve, to use a metaphor, than the staff has assumed in its projection. By the same token, we believe consumption expenditures probably are going to be a little greater because of the low interest rates and the low inflation and the high increases that are occurring in personal disposable income. And I think this tax bill probably will have a positive effect upon consumer expenditures. I end up by saying that if we do achieve the results the staff is projecting I think that's a darn good set of results for this stage of a business cycle, given all these structural problems that we have in the economy now. I don't think we can hope for much better than that.

MR. ANGELL. I, too, would like to respond to Bob's question; it's a very good question. It's easy to say somebody's forecast is wrong without trying to do your own. I would tend to put off by maybe up to two quarters the improvement in the net export picture. The staff has a $26 billion improvement shown between Q3 and Q2 and a $28 billion improvement of Q4 over Q2. It seems to me that that could be very difficult to accomplish, particularly because oil prices might be causing people to want to have higher oil inventories--and higher oil inventories don't come out of U.S. production, they come out of more imports. If that export picture doesn't improve then it seems to me somewhat difficult to get quite as much improvement in the U.S. government budget deficit as shown. So, I would just tilt a bit in that regard. I think there is a reasonable chance of getting the [staff's] 1987 growth rates in the export sector; if we don't we're in trouble.

CHAIRMAN VOLCKER. Anybody else have any general comments? Governor Wallich.

MR. WALLICH. I'd just [emphasize] the point that I tried to put out before. It seems so simple to say but it still is very difficult for me. I hope you'll just bear with me; maybe I will not say anything now.

CHAIRMAN VOLCKER. Anybody else? If not why don't you give us a little run-down, Mr. Kohn, and we'll go and eat a doughnut.

MR. KOHN. [Statement--see Appendix.]

[Coffee break]

CHAIRMAN VOLCKER. Reverting to Mexico for just a minute: Mr. Truman pointed out to me that the IMF has more than you want to know about the Mexican program in an IMF document, which he will be glad to make available to you. It is only 53 pages, single-spaced.

MR. TRUMAN. It's 68.

CHAIRMAN VOLCKER. Sixty-eight, single-spaced or-double spaced. I have reached the advanced age where I can't read IMF documents. I haven't found that a great loss. Returning to our present problems and dilemmas, I think we are in a situation where there aren't any good choices. Let me just make a couple of points.

A number of the Reserve Banks have proposed a reduction in the discount rate. I think that is obviously on the table as a policy variable in the period immediately ahead. [We'll be] judging more after the conversation than before in terms of how desirable that is.

I have a few comments on the international setting which, of course, we can't expect miracles from, given all the lags. But it is rather [unintelligible] in the short run in terms of exchange rate movements and somewhat [unintelligible] I hesitate to say in the longer run, but not immediately in terms of prospects for growth abroad. I think the situation in Germany, which is of course typical in Europe, is dominated by what appears to be a rather satisfactory--and they would almost say better than satisfactory--economic outlook, as they read it. They did not do well for a couple of quarters or more; but apparently the gross national product will have a very large rebound in the second quarter. The decline in the first quarter was probably partly statistical and the increase will be partly statistical, they think, however you look at it. I don't know whether it will be as strong as they think, but they are expecting the data to show a very strong second quarter. And they are anticipating a continued pretty good rate of growth, in the area of an annual rate of 6 percent or more, through the rest of this year anyway. It remains to be seen whether that materializes; they need that kind of growth to come up to 3 percent year-to-year increases, which is what they were talking about earlier. At some point we were talking 3-1/2 or even 4 percent; we're clearly not going to make that. Still, in their view, they think they'll make the 3 percent, which requires rather strong growth from now on.

German monetary growth is significantly in excess of their target--not significant in our terms, significant in their terms. They usually meet their targets and that doesn't give them any eagerness to move. If you just look at Germany, I think that is all understandable, if you have any confidence in their outlook. The German failure to move on the discount rate not only gives us problems in terms of the immediate exchange rate repercussions of what we do but I think it also, rightly or wrongly, blocks action elsewhere in Europe where the economic outlook is not so ebullient. The French and the British have been very reluctant to move because of their concern about their own exchange rates vis-a-vis the mark if the Germans don't move. They would be delighted to see the Germans move. Whether the Germans move or not, I think there is virtually no chance of their moving on their own initiative. Whether they would move under some pressure within Europe instead of pressure from the United States--. That may be counterproductive because they have made it an issue of national honor not to respond to external pressure. But I think there is a reasonable chance that they would move if other people move first and the exchange rate, in fact, reacted. Then they could just throw up their hands and say: We don't think it is a good idea but external developments give us no choice. That is not certain, but I think it is a reasonably good prospect. In fact, I think that

As for Japan, I don't feel I know much about the outlook there. I don't see any reason for thinking it is as strong as the Germans think their outlook is. It looks like a very sluggish picture being affected by the external squeeze, if that is the right word.

It's hard to call it a squeeze when they have a surplus of $70 billion or so. The external surplus is no longer rising except as a result of the oil price decline, and I guess there are some real declines in their exports that feed back into their domestic growth. They do talk about putting together some kind of a fiscal package, but I think that really has a long fuse on it in terms of affecting the economy. That doesn't do us much good in the immediate exchange market situation. Again if they move at all, [it might] be merely a reaction to being forced into it. I haven't had any real contact with them recently but it doesn't sound all that encouraging.

The other point is that certainly the Germans, and I am sure the Japanese, would be much happier if we would intervene, along with them, at some rate not very far from today's rate. We might in some sense be close to a point of "buying" a discount rate decline in exchange for a promise to intervene visibly, if not aggressively, to support the dollar. I am not sure that wouldn't be a reasonable bargain for us to make, but the bargain has not been struck anyway. They would like us to intervene without them doing anything, which just isn't a negotiating posture; I don't think the United States will find that acceptable. Conceivably, if everybody moved that might be a way to encourage some action. I think the upshot of it is--I am sure in the case of the Germans, I can't be absolutely sure in the case of the French and the English or the Japanese [unintelligible]--that if we move in the immediate future, within the next week, I don't think they will do anything; but they might do something in reaction to what happened.

MR. RICE. I don't understand that last point. If we lowered the discount rate, the Japanese would not follow us but would instead intervene to maintain--

CHAIRMAN VOLCKER. Well, I think they would probably intervene too, but what they'd like us to do is intervene. They kind of say: Well, you go ahead and reduce your rate and then we will all intervene to support the dollar. The Germans would say that too. You go ahead and reduce yours if you think it is necessary and then why don't we all conduct joint [intervention].

MR. RICE. And as a last resort--

CHAIRMAN VOLCKER. No, I'm saying I think it might be a reasonable view that they also would reduce their rates.

MR. RICE. I see.

CHAIRMAN VOLCKER. Now, I am not sure that the Treasury would think it is a reasonable deal. I am saying that from my point of view it seems a reasonable deal.

MR. GUFFEY. The last time we took the lead in reducing the discount rate there were clearly great expectations, I thought, that some of the secondary countries such as France, the United Kingdom, and others would follow along, and they did not.

CHAIRMAN VOLCKER. I tell you there were very clear expectations; they had told me they would. What changed their minds was that during that week both the franc and sterling weakened, in their terms, significantly. That probably [now] appears as a very small blip on the charts. But they were both very sensitive to that fact. We probably discussed that as late as a Tuesday, at an Open Market Committee meeting, and they had told me the previous weekend that they would move. But on Wednesday, Thursday, and Friday, or at least on Thursday and Friday, their exchange rates weakened--the British pound because it kind of got caught up in this oil situation and the French franc for other reasons, I think. They just felt uneasy about moving when their exchange rate was weakening. And that is the same hang-up they have now since the franc has weakened further against the mark. What is sterling doing?

MR. TRUMAN. It has gotten some strength but net, on balance, it's down against the dollar.

CHAIRMAN VOLCKER. I think both the British and the French are probably in an untenable position. They would both like to ease but neither wants to pay any price in terms of their exchange rate.

MR. GUFFEY. Then you wouldn't expect them to move until Germany moves?

CHAIRMAN VOLCKER. Well, I think the answer to that question is no. Whether I would exclude it entirely, I don't know. I am afraid neither of them will move without the other moving and I just [unintelligible]. I can find that out, but my suspicion is they won't. I can't entirely exclude a move, but the straight answer to your question is: I wouldn't count on it purely because of [concern about] exchange rate movements. There is no doubt that they would like to move. If the Germans moved, [the British and French] would move in a second. But one thing I am sure of is that the Germans aren't going to move in a second.

MR. BOEHNE. Is the timing issue with the Germans a question of the time between when the Federal Reserve would move and when they would move? Or is their timing dependent on some other factor?

CHAIRMAN VOLCKER. I wouldn't characterize it as a timing issue. From their basic standpoint, they don't want to move. Just look at their internal situation. They might move in response to external developments and a very strong mark. That would make the move come later in time, but it is not that they think it will be great to move in September as opposed to now. If nothing changed and they weren't under any pressure to move externally by September, they wouldn't move in September either. They basically don't want to move. And that is easy to understand, if you just look at their domestic picture and you give credence to their confidence about their own outlook. It may not be as ebullient as they say, but that is what the argument is; it does look strong if you just look at Germany by itself. They have had a big increase in real income because of the exchange rate and oil. They have had a pretty big wage increase and no price increase is another way of looking at it. They have a very strong consumption picture at the moment; I don't know whether to call it a boom because it hasn't been going on that long. But they had strong consumption in the first quarter when GNP went down. They were estimating--not in our terms, but the way they look at it--an increase in real consumption at a seasonally adjusted annual rate, I forget the exact figure, of 12 to 13 percent in the second quarter. Now, those are partly phony statistically because they don't make working day adjustments. I don't understand it: they seasonally adjust the figure but they don't adjust it for working days. I guess it is a straight seasonal adjustment procedure and it doesn't take account of different numbers of working days. They have a sharp alteration of working days between the first and second quarters, so the first quarter wasn't as bad as it looked and the second quarter won't be as strong as it looks statistically. But nonetheless, it will look strong--they think very strong.

MR. KEEHN. If we moved unilaterally and the Germans did not, what kind of pressures would occur on the dollar? Or is it on a slightly different track than it may have been in the past?

CHAIRMAN VOLCKER. Well, it is anybody's guess, I suppose. You would think that the dollar might [weaken], given not very strong confidence in the market. Anyway, it would depress the dollar but that is the chance you take. How much, how far? I don't know whether Mr. Cross has any inside story.

MR. CROSS. No, I don't have any inside story. But I certainly know that a great deal of attention was paid to the fact that we moved unilaterally without the others the last time. That made quite an impression in the market and I certainly think they are watching very closely. There is a risk there, but it is hard to assess how big it would be.

MR. MELZER. We had a 4 to 5 percent decline in the dollar against all the other major currencies. I would think that would even accelerate.

CHAIRMAN VOLCKER. Well, peculiarly, it went up for a couple of days [unintelligible] then came down.

MR. GUFFEY. They spent quite a large sum of reserves supporting it.

CHAIRMAN VOLCKER. The Japanese--

MR. CROSS. The Japanese fought it.

MR. GUFFEY. Hasn't Germany as well?

MR. CROSS. No, Germany has not.

MR. MELZER. Part of the psychology with respect to the dollar seems to be looking to the level of economic activity here. To some extent you would think, initially, that a pickup in activity here would be a positive factor, some kind of insurance policy. Then I think about what we were talking about earlier: that the risk, if you will, is on the consumption side. If the consumption side picked up one could conceivably feel initially, given that psychology, that the pickup was an insurance policy--insurance that we wouldn't get into a free-falling situation. But I worry a little about that psychology turning on us because if our consumption did pick up we could continue to run large trade deficits. At some point, inflationary psychology could possibly start to filter in there and [with it] the unwillingness to continue to hold dollars at these rate levels or however you--

CHAIRMAN VOLCKER. I agree with that; people can make that argument. I wouldn't put much weight on this. What if we ease? Let's say we reduce the discount rate and that would make people feel so good about the economic outlook that the psychology of the economic outlook would outweigh the change in interest rates. I think that is a theoretical possibility. In the practical sense, [the probability] that a half percent reduction in the discount rate is suddenly going to make people feel ebullient about the business outlook is close to nil. If it did, I think you would forget that psychology. I just think the chances of that happening are extremely minor. Now, if it was followed not just by strong consumption figures but by accident you got stronger investment figures and you had good employment figures for August then, yes, the dollar could strengthen regardless of what we did on the discount rate. I don't think it will be because we reduce the discount rate.

MR. HELLER. Your own staff projections assume already a decline of the dollar of 10 percent to make the projected trade picture come true. So, if we don't get any dollar decline at all, presumably the trade picture would be a lot worse than--

CHAIRMAN VOLCKER. If you put a lot of weight on our staff forecast, that's right.

MR. HELLER. At least for consistency purposes. Well, the feeling around the table was that people were a bit more pessimistic than the staff was, so you clearly need the exchange rate story--

CHAIRMAN VOLCKER. Analytically you are correct, if your starting assumption is correct. One of the real dangers we have here --it may be more apparent in the case of Japan now than in Germany--is that that same dollar decline would further depress business activity and expectations in Japan. It works against you. You may gain on the price side and lose on the income side.

VICE CHAIRMAN CORRIGAN. You kind of stretch out the J-curve in the process.

CHAIRMAN VOLCKER. In nominal numbers you stretch out the J-curve.

MR. JOHNSON. That is one of the problems if they just continue to resist on their discount rate.

MR. ANGELL. But it is something of a problem, it seems to me, to assume that we know that at the current level of the dollar the trade will work when that J-curve is fully operational. If we were to make a stand on the dollar at this point and turn out to be wrong--

CHAIRMAN VOLCKER. When we talk about intervening, I am not talking about a life or death struggle to protect any particular level of the dollar. My own feeling is that if we are not competitive, particularly against the yen, at these levels heaven help us. I don't know how we will get out of this problem. But that may only be evident in a much more fully employed economy abroad where there are some pressures on capacity and all the rest. And we are some years away from that. That is not going to develop this year and it isn't going to develop next year; it may develop in 1988, but you've got to wait until 1988.

MR. ANGELL. That hurts us, not just with regard to our exports to Japan, but it hurts us with regard to our exports to many of the [unintelligible] and the Third World countries where Japan is going to try to make up for their lack of growth in [exports to] the United States. They are going to try to beat [us in] those other markets.

CHAIRMAN VOLCKER. If you look at Japan as the big surplus country in the world, which it is, and say that is where the adjustment has to fall, the adjustment is not necessarily in trade with the United States but in trade with Third World Countries. When you look at how [un]willing they are at any exchange rate to welcome more textiles from Korea, or more cars from Korea--or steel, I guess, is the more relevant product from Korea--they are going to scratch and dig and resist importing steel from Korea like crazy even though Korean steel is selling at half the price of Japanese steel. It may happen over time but it isn't going to happen very fast. The one developing country that is running a big surplus on current account--the others aren't running big surpluses--is Taiwan. Their current account is really huge; for the size of the economy, it is absolutely enormous. That is the one LDC that has an adjustment problem of its own. Korea has a lot of debts; they are not running a big current account surplus. Canada is not running a big current account surplus; Singapore isn't; I don't even think Hong Kong is. Taiwan is, but that is only one country.

MR. HELLER. On current account you also get the big statistical discrepancies worldwide--

CHAIRMAN VOLCKER. Half of our deficit is in the rest; its counterpart is the statistical discrepancy.

MR. HELLER. So that is a lot worse in the current account than the trade account.

MR. WALLICH. I think that what we need is a lower current account [deficit] and that means less favorable international relations.

CHAIRMAN VOLCKER. We need a lower current account deficit, I think, over time. The question is, how do you get there without--

MR. JOHNSON. I don't think we want to create a psychology that would lead to a real impression that we were aggressively pursuing a lower dollar policy. I think that is something we should try to avoid at all costs; at the same time, I wouldn't be that upset by some sort of symbolic intervention--because I think that is what it would be, basically.

CHAIRMAN VOLCKER. If we were intervening, just to make it clear, I presume what we would do is intervene around 150 yen, which is already lower than what it is now, and 200 marks. Getting down to there, say, with a reduction in the discount rate, would be very easy to contemplate. We are already about one-third of the way to the reduction that Mr. Truman is projecting for an 18-month period.

MR. HELLER. I want to come back to the interest rates and the exchange rates. To not cut the discount rate or lower interest rates in order to avoid the drop in the exchange rate I think would really give the wrong signal to all our foreign countries. And that is exactly what you are saying. By doing that, you are in essence forcing their domestic hand, which you want to do anyhow. That is where you want to be and the exchange rate is the threat--

CHAIRMAN VOLCKER. I don't seem to "force" very well.

MR. HELLER. Well, then the exchange rate is the thing that will do it eventually. I am the last person who would like to see a low dollar for international financial purposes. But on the trade front, it may forestall the protectionist [unintelligible].

CHAIRMAN VOLCKER. On the protectionist side, we are running out of steam. This point of protectionism is the same: I don't care where the dollar is, I don't see any results. They just want protection in the same period but it doesn't hurt [unintelligible]. But I think we could have managed in the worst of all worlds where you get a lack of confidence in the dollar and it damages their outlook and it damages our outlook at the same time and forces interest rates up in the end instead of down. Then we are in an unholy mess. But we are playing on the fringes of that whatever--

MR. MELZER. I noticed--I may be pre-conditioned to look for this sort of stuff--that in the last month there seem to have been a lot more stories in the popular press about reviving concerns domestically about inflation. I have seen three or four different ones and I don't think we can lose sight of that either in looking at our monetary policy in the context of the purely domestic setting.

MR. BLACK. I would like to latch on to that because I agree with Tom on that. We have a lot of problems in this country, no question--in agriculture, manufacturing, energy, and so forth. The near-term outlook for investment certainly doesn't appear to be very good. But most of these problems are due to such things as structural changes in the international market, the federal budget deficit, and uncertainty over the impact of the tax bill. And there is not a lot we can do about that with monetary policy. We could undo a lot of the progress on inflation if we overlooked those concerns.

CHAIRMAN VOLCKER. To my mind, the problems are not very soluble. I see that time is passing. Maybe we better get to a decision here. Just in the interest of short circuiting this, given the time--I don't want to short circuit any discussion that people want to have--I suspect that the idea of tightening monetary policy at the moment is not very appealing. [Hearing no objection] we can reject that option. If we were going to ease, in the broader sense, I am not sure that the best way to do it is by easing what is already a very easy open market posture. That leaves me the very easy decision, insofar as open market operations are concerned, that we have to stay about where we are. That leaves open the question of the discount rate very specifically.

MR. RICE. Well, I think you said it.

MR. JOHNSON. If we did that, that would put us in a posture like the last time: the same borrowed reserve target and a lower discount rate and a lower funds rate.

MR. RICE. No, I meant that we ought to stay on the current policy course and not move toward ease.

CHAIRMAN VOLCKER. Let me just make a little artificial distinction and ask, regardless of the discount rate: Would anyone want to argue differently than staying roughly where we are? Actually, we've been playing it slightly on the easy side from where we were about one month ago--you can see it in the funds rate--when you adjust for Tulsa, Oklahoma borrowing.

MR. HELLER. May I ask you a quick question? Please rule it out of order if you don't [think it's appropriate]. In the Bluebook, and also earlier in the discussion, it came up that [the staff] expects monetary growth to slow down in the next two or three months.

CHAIRMAN VOLCKER. We often expect that and it often doesn't happen.

MR. HELLER. Well, it is a very comforting thought. Why?

CHAIRMAN VOLCKER. I don't put much weight on it, but if I may summarize--Mr. Kohn can go on and give you a more erudite answer--when you put this stuff in the equations and you assume no short-run change in interest rates--and there hasn't been much in the recent past--the result always comes out that monetary growth will slow down. Whether it does or does not depends upon what [else] happens. But that is the way the equations tend to look.

MR. JOHNSON. One-time adjustment to the change.

MR. KOHN. I am not sure whether this is more or less erudite. I think there are two things working: one is that some of the boost [to M2 growth] in July was what we think was a one-time spurt because the banks did accumulate record volumes of Treasury securities and financed them with overnight RPs, which end up in M2. So we don't--

MR. MORRIS. Why is it a one-time spurt?

MR. KOHN. Well, we don't know; we are assuming that. It was a record; it was unusual; it broke a pattern; and our understanding from contacts with the banks is that it was in large measure an interest rate play, particularly in the early part of July, given an anticipation of a discount rate cut. It continued a little past that but it was an unusual event that we wouldn't necessarily expect to be repeated. That can't be ruled out.

MR. MORRIS. Typically in our banking system, when we are pumping in reserves greater than are needed to finance loan demand the banks naturally put the remainder in the securities markets. The question is: Why is it going to be different next month?

MR. ANGELL. But they don't necessarily repo them.

MR. BLACK. You have a chicken and egg question here, too, as to whether they buy these investments and then we supply the reserves to support the deposits created or whether we're putting the reserves out first.

CHAIRMAN VOLCKER. We're really putting the reserves out second.

MR. JOHNSON. Reduced interest rates--

MR. ANGELL. Because, otherwise, they wouldn't repo them. The reason they repo them is because we didn't put the funds out.

MR. JOHNSON. We are following the market.

MR. KOHN. The other facet, I think--and it relates a little more to the Chairman's comments about the equations--is that, in a relatively stable interest rate environment, we would expect offering rates on these time deposits, even on the more liquid deposits, to come down and adjust to the current level of market rates. And that should slow down some of the shifts of assets into M2.

CHAIRMAN VOLCKER. Actually, I guess CD rates now are quite low relative to the present discount rate; they are right on the discount rate.

MR. KOHN. Right on it, practically.

CHAIRMAN VOLCKER. If I understood Mr. Kohn right earlier, he was saying that if you combine an unchanged open market policy with a reduction in the discount rate, the probabilities are quite high that you will continue to get very rapid monetary expansion.

MR. PARRY. What is the assumption about borrowing?

CHAIRMAN VOLCKER. Say, around $300 million of real adjustment borrowing, discounting this Oklahoma situation.

MR. JOHNSON. Your target here does not assume anything on the discount rate?

MR. KOHN. Well, alternative A is consistent either with a discount rate cut or continuing the $300 million--

MR. JOHNSON. Okay.

MR. PARRY. Wouldn't "B" be roughly consistent with that? It seems to me that "A" would be consistent with a discount rate change of more than one-half point.

MR. KOHN. Our estimates of the monetary growth we would expect at current interest rates we put under alternative B.

MR. PARRY. Oh, really? But you have a midpoint on the fed funds range which differs by a full percentage point. That's all [unintelligible] associated with "A" or "B," one-half percentage point.

MR. KOHN. The ranges for the fed funds rate are more symbolic than real. That is, they weren't necessarily centered on the midpoint of the fed funds rate we were assuming.

MR. ANGELL. We have a bit of double counting here; last time we changed the fed funds range a full point with a half-point change to the discount rate. I would think we wouldn't want to change the fed funds range from 4 to 8 percent. I don't see where that is warranted.

CHAIRMAN VOLCKER. [Unintelligible.]

MR. JOHNSON. I think you want to do something to the midpoint to reflect the discount rate change, not the funds rate range.

CHAIRMAN VOLCKER. We changed them the last time.

MR. JOHNSON. Yes, okay.

MR. PARRY. Just to pursue the point a little further: If we reduce the discount rate 50 basis points and keep borrowings at the current level, it seems to me we're talking about a funds rate that is about 5-3/4 percent. That seems to me more consistent with "B." I would call that more "B plus" than "A." So it would seem to me logical to go for alternative B even if one were in favor of a half-point reduction in the discount rate.

MR. JOHNSON. Wait. Do you mean by that, Bob, that you are just interpreting "B" as consistent with $300 million of borrowing?

MR. PARRY. No. I am not talking about keeping borrowing the same in both discount rate environments.

MR. BLACK. But with the fed funds rate down to 5-3/4 percent wouldn't you think that was easier?

MR. JOHNSON. Well, that is what I think Don was--

MR. PARRY. No, I am saying I think it is closer to "B" than to "A".

CHAIRMAN VOLCKER. I don't think we ought to worry about whether it is precisely "A," "B," or "C." At this stage, we ought to decide what we want to do. There may be disagreements about this because people have different ideas about what should be done with the discount rate. I guess I am arguing that the decision ought to be left to the discount rate as the more appropriate tool now. Whatever way that decision goes, the question in essence is: [Do we want borrowing of] something around $300 million or a little less than $300 million if the discount rate doesn't move?

MR. GUFFEY. My preference would be for a discount rate decrease of one-half percentage point with the $300 million borrowing level, which would result in roughly a 5-3/4 percent [funds rate]. Or, if we wanted to go some place between "A" and "B," if you will, to raise that borrowing level to the $400 million range as opposed to the $300 million range would give us some flexibility if we wanted to go on down adjusting the borrowing range. But in terms of the greater question as to whether or not I would opt for some ease, the answer is yes. The way I would love to do it is with a discount rate decrease. I would not favor some lesser borrowing level because I think we are getting fairly close to some sort of frictional level. We could lose control. Then, you are right on an interest rate target. The second part of that recommendation does include the international. It seems to me that we are the only catalyst and have the only tools that would make the Germans and the Japanese move if they are going to move at all. If we don't move, they are not going to move. To the extent that the lower dollar would help us on exports, or as an alternative that they would move and give us a little more stimulation, I think that is the prescription that we need to follow.

CHAIRMAN VOLCKER. The assumption you make is the only operational assumption now with a high degree of probability to be right--that they are not going to move without us.

MR. GUFFEY. I thought that was the sense of the discussion.

CHAIRMAN VOLCKER. And they may not move with us.

MR. GUFFEY. I understand that. But if they do not, then the dollar will fall in some relationship to their currencies and make us more competitive in international markets. Either one of those two: if they move, that would be the better of the two; but if they don't then we get, hopefully, some benefit from a bit of ease domestically.

CHAIRMAN VOLCKER. Governor Johnson.

MR. JOHNSON. That's my same sense except that I prefer to keep the borrowing level about where it is, at about $300 million. And, I think something like a half point on the discount rate might be pretty good.

MR. RICE. I support that too.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, I was just going to go back to the forecast, Mr. Chairman. I think that the Board staff's forecast is a reasonable one but I think it is fraught with an awful lot of uncertainties. And frankly, I think that the risk is on the down side, both with respect to the trade deficit and consumer spending. There is an awful lot in this tax bill that could turn consumer spending around one way or the other. With that kind of uncertainty and the risk I see for lower growth, I think that some move toward further accommodation is called for. Now the method of doing that [involves], obviously, some difficult judgments. My preference would be to keep the borrowing at $300 million and to move the discount rate by 50 basis points. Having made a few of these discount rate cuts over the past several months, I think that we're perhaps at the point that we may, in fact, be forcing the Germans and Japanese to make a corresponding move. But even if they don't I think we should go ahead. In the absence of their moving, if there were considerable concern about selling pressures on the dollar, then perhaps lowering the borrowing to a frictional level of $150 million and no discount rate change--in order to probe the fed funds market--might be called for. But that would not be my preference; I would prefer a rate change and approximately $300 million on borrowing.

CHAIRMAN VOLCKER. Mr. Stern.

MR. STERN. I have to admit that I am concerned about what we are talking about in terms of reducing the discount rate at this time. I am not fundamentally opposed to that kind of move, but I think the timing is critical. It seems to me that we are sitting here in a situation where we have very little data on the current quarter but the data we do have--both employment and retail sales numbers--are on the positive side. We had rapid growth in the aggregates in July; we don't know with much conviction what they are going to do going out, but we are certainly coming off that. We have been listening to Sam and others talk for some time now about the vulnerabilities of the dollar and this just does not strike me as a very opportune time to take this step. I certainly can see circumstances going forward where the environment might be far more preferable to the current one. So, I would be somewhat hesitant at this point. I can certainly live with "B" as specified, but I am not very comfortable about a discount rate reduction soon.

CHAIRMAN VOLCKER. Mr. Melzer.

MR. MELZER. Gary, you have said everything I was thinking--almost. I would agree with that position in general. I have just a couple of other observations. It seems to me that we are taking, in a sense, a marginal approach to policy. If we take a look at what has happened in the intermeeting period in terms of the economy and we are not happy with that then we think about easing policy further. And I am not sure that we have given enough time for the accommodative policy that we have been pursuing for some time to take effect. I am concerned about the risk that Gary cited and I share his feeling about the outlook right now. I mentioned some of the commentary in the popular press about inflationary expectations seeming to be reviving; I might also mention that long rates since two discount rate cuts ago are actually higher now than they were then. We have had a steepening in the yield curve. I have a little trouble with the thought that somehow lower rates are going to help the economy here. I think the market place, in a number of different ways, is telling us to be careful in terms of inflationary expectations. So I would be in favor of alternative B, the $300 million borrowing target, and no change in the discount rate.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. I am very closely in agreement with Gary Stern and Tom Melzer on that. I consider this scenario that the staff has traced out in its projections to be a very fine outcome for this [stage of the] cycle--in the fourth year and into the fifth year. I can see the arguments on the international side, but trying to nudge these other countries into action--. I just can't see how any further easing will do anything to our domestic problems, most of which can't be addressed by monetary policy. The aggregates are running through the ceiling and I can see and understand very well why we've downgraded M1. I even agree with that, which may surprise some of you. But somewhere along the way the aggregate numbers are going to mean something. And at some point we are going to have to get back to some kind of procedure in which targeting aggregates and trying to hit the targets is part of [our policy approach]. Or else we are going to be back in an inflationary environment somewhere along the way; I don't know how soon, but it is coming. So, I just can't see the case on the domestic side at this point.

CHAIRMAN VOLCKER. Mr. Wallace.

MR. WALLACE. Mr. Chairman, as you know, we have supported a further discount rate cut and, therefore, I would support the approach that others have expressed around the table. However, in the absence of that, in view of what I would regard as continued weakness in the economy--especially from where I sit--I would favor an action such as alternative A. I think we should use this window of opportunity to let interest rates move down further before we are faced with the reality of a resurgence in the inflationary [unintelligible]. But if the discount rate cut is in prospect, then I would favor [that].

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. Mr. Chairman, I favor a borrowing level of approximately $300 million and a half percentage point cut in the discount rate. My view is conditioned by my outlook for prices. I suppose four years of a rather steady number of around 4 percent followed by this remarkable year, even when you make adjustments for energy and food, draw me to conclude reluctantly that the outlook for inflation may be reasonably good. I say I view that reluctantly because I have great concerns that, with the kind of money growth we have been seeing, we do have a long-term problem with inflation. But now I view the current environment as a moment where we do have room for ease because of the inflation picture. So, my recommendation for easing is not based so much on my view of the outlook for the real economy as it is on my outlook for inflation.

CHAIRMAN VOLCKER. Mr. Morris.

MR. MORRIS. Well, Mr. Chairman I would like to associate myself with the Stern and Melzer camp. I have an intuitive feeling that 1987 could be significantly stronger than we are now thinking for two reasons: (1) I don't think we know much about the timing or the amplitude of the decline in the exchange rate; and (2) I don't think we know much about the economic impact of the tax bill. That could cut both ways, but I think it does mean that there is a possibility that we could have a significantly stronger 1987 than we are now thinking, even though I can't give any numbers to document my gut feeling. I am also impressed with the fact that we are generating a lot of liquidity in the system. Maybe Don is right that we had a one-shot jump in July. But even though I haven't been known to be a slavish follower of the aggregates, I am concerned about the buildup of liquidity in the system. Sooner or later that could cause problems. So I think we are in a situation where we ought to exercise a little patience, at least until the next meeting, and adopt a "status quo" policy here, which I interpret alternative B to represent. I would like to see us wait a little longer before we move on the discount rate.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. While our economic outlook continues to be positive, I do think there are some growing risks that loom on the down side and I think we would have a better opportunity to maintain the growing economic expansion if we were to reduce the rate structure somewhat. Real rates continue to be a little on the high side. I think that we have an opportunity here to reduce the discount rate and I would be in favor of doing that. Therefore, I would recommend that along with a borrowing level of $300 million. Certainly, this whole issue is vastly complicated by the international situation, which is terribly tough to judge if you are not intimately involved in it. But I think, as others have said, that there is a chance that if we were to do a discount rate cut, it would put some additional pressure on the other central banks to move and, therefore, I would be in favor of doing it.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. Since I am concerned with the general sluggishness of the economy and the specific areas of significant weakness, I think that the risk in the staff's forecast for the next six months and for 1987 is probably on the low side, particularly because of questions about tax reform and the various points made about international developments. I can live with alternative B, assuming that it will be accompanied by a half percentage point discount rate cut and a borrowing target of about $300 million.

CHAIRMAN VOLCKER. Mr. Corrigan.

VICE CHAIRMAN CORRIGAN. I support alternative B with borrowing at $300 million. But along with all the other worries that I have I must say that I also have the worry that there is at least some danger that we could be sowing the seeds for a greater inflationary problem down the road. It appears to me that at least in terms of the price effects, the beneficial effects of the oil situation may already be behind us. Import prices are rising and are certainly going to rise more. Indeed, if they don't rise more the chances of getting a correction in the trade balance are diminished. The service sector doesn't look all that hot from a price and wage performance [perspective]. And like Frank, I am not very slavish on any of the Ms but I can't completely disregard the pace at which all of them seem to be growing, at least at the moment. Partly for that reason, I am not so keen at this precise moment on the discount rate part of the package either. I certainly would be keen on it in a context in which I felt some greater assurance that we might get some support abroad. Even aside from that, I guess I am not quite sure what a discount rate cut does now. Clearly, it reduces debt service burdens--not just for LDCs, but for everybody. That is good, if it doesn't have the perverse effect of encouraging still more debt. But the effects of lower interest rates in the short run in terms of the exchange rate, in terms of the trade account, and in terms of stalling the prospects for growth in Japan and elsewhere, are really big question marks to me. It is just not clear, aside from that debt servicing aspect of it, what a lower discount rate is going to do. And ironically, I suppose, I see some danger that it could have some perverse effects. Now, I think those perverse effects would be greatly minimized in the context in which there was some greater prospect for movements elsewhere. Unfortunately, that doesn't look so good. In that setting, if the discount rate has to come down, I probably would be inclined to tilt open market operations and borrowings on the up side. We have been rather systematically tilting operations on the side of ease and tilting borrowings on the low side. In a setting in which the discount rate were reduced, absent moves abroad, I would be inclined to reverse the tilts.

CHAIRMAN VOLCKER. Mr. Parry.

MR. PARRY. I would favor alternative B. I have many of the same fears that have been mentioned by Presidents Corrigan, Stern and Melzer about an easier policy. I am especially troubled by the implications of an easier policy as far as the growth of the aggregates is concerned. With regard to the discount rate, I think a case can be made that there is no urgency at this point and that, really, there probably is a reason to delay a decision for a couple of weeks. In the next couple of weeks we are going to get a lot of data about the economy. Although that may not provide any definitive information, it is certainly going to provide a lot more information about the beginning of the third quarter than we have at the present time. So, it seems to me that "B" with no change in the discount rate is a reasonable course to follow for the next couple of weeks.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Well, when you total up the reasons for easing or not easing, I find them fairly evenly balanced. But I come down on the side of not easing at this point. I don't feel any great compulsion for a drop in the discount rate. So, my preferred course would be to sleep on any change in the discount rate for several weeks and keep open market operations around alternative B.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, I favor alternative B with the view that we ought to stay about where we are with respect to the growth in the aggregates. I expect that the economy is going to turn out to be very difficult to get a grip on. And I would agree with some of the views expressed earlier that we don't need a discount rate cut for domestic reasons. I don't see what it will do to improve our situation domestically. However, I think the argument for reducing the discount rate to prod the Europeans and the Japanese to stimulate their economies is an important one. That turnaround in net exports at the present time is probably very crucial to maintaining a satisfactory rate of expansion in our domestic economy and in my view the way to move in that direction would be to reduce the discount rate along with alternative B. No one wants to add to liquidity in the economy right now, but I think the risks of not trying to do something to affect the trade sector are great enough to assume the risks that go along with expanding the liquidity in the economy and so forth.

CHAIRMAN VOLCKER. Governor Angell.

MR. ANGELL. I am very sure that monetary policy does matter. That's why it's such a difficult call here. I don't share the notion that it doesn't make any difference; I think it makes a great deal of difference. It seems to me that we have more balanced risks to worry about this time than I [saw earlier]. I don't like easing in the face of the monetary aggregates being where they are. I don't like easing when I have a sense that commodity price developments suggest another outlook. At the same time, I think there is a greater risk that this [economy] could deteriorate further on us and compound government revenue [problems] by growing at a rather anemic rate. I think that's a pretty dangerous risk. I think there is a dangerous risk in that the world trade pattern is still stagnant, not expanding. I think that Tom Melzer and Gary Stern are right when they say that inflation expectations have changed. But that's what worries me on the other side, because I see inflation expectations rising and the rate of inflation not rising. And that tends to cause me to believe that output is going to be slow, not fast. So, given this severe difficulty, I am very hesitant about being on the side of an easier stance which could best be accomplished by a discount rate cut and leaving borrowing at $300 million. But I do believe that we are in a place where if we do get some indication that prices are moving too high that we then have to be prepared to take the next step--which would be to say that discount rates can go up as well as down. I have very little faith that we are going to be so accurate as to get this thing tuned just right without overshooting, but I am afraid not to take the steps. So I am reluctantly for easing.

CHAIRMAN VOLCKER. Mr. Heller, will you add something on your maiden voyage?

MR. HELLER. I think I can't wait any longer here. Listening to the discussion, it's just about evenly divided between the discount rate cutters and noncutters. I think that shows how tough the job is going to be. As far as monetary policy is concerned, I think it's very important to preserve the credibility of the Federal Reserve, to stick to preannounced targets and not to get out of the target ranges. The A alternative gets awfully close--if only I had my bifocals--to the line that I would really like to stay a bit below. I would agree very much with the discussion around the table about alternative B. As far as the discount rate is concerned, as I look at the economy, I don't see that much strength in the immediate future. Given consumer spending and the high consumer debt levels that are already there and the prospect of not having these consumer debts tax deductible in the future, I think consumer spending will be soft during the coming year. On the investment side, I certainly don't see any prospects for sharp increases in investment and the fiscal picture, with the tax reform, would support that view. On the trade balance, as I said earlier, I am not quite as optimistic as the forecasts that have been made by the staff. It clearly will improve, but I think it will be very rough going, especially in Europe. Therefore, largely for the international reasons that also were cited by Mr. Rice, I would favor a discount rate cut at the present time.

MR. JOHNSON. Some people said alternative B without specifying a borrowing target. I am a little confused--

CHAIRMAN VOLCKER. [Unintelligible] I think we have got to try to get a decision. Governor Wallich.

MR. WALLICH. As I look at the longer run, I am more concerned about the inflationary effects of this--what it might be with a 6-year [unintelligible]. So I would go with the monetarists and say we cannot go on with the M1 and M2 growth that we have been having. That just can't go on indefinitely. Easing, by the same token, presents an element of risk. So regretfully, I think that we have to work at the present level of operation.

CHAIRMAN VOLCKER. I think all of the situations have been eloquently described here and they leave most people with a sense of some unease because we are fine-tuning around what is hopefully a bottom. The good news is that we are trying to fiddle around with the correct amount of shading, possibly further ease, in the hopes of maybe [unintelligible]. There is no way of squaring the circle and I haven't really tried, but I feel for the views that have been expressed on both sides. We are sitting here pumping up liquidity and pumping up debt at the same time, and somehow no good comes of that in the long run. I don't know whether it's [inflationary] or what. What I would suggest in listening to this is probably the [unintelligible] to the widest possible consensus, partly because I think it is probably right. I think it is probably right in probing around specifically for the operational language here to say that the Committee seeks to "decrease slightly" and leave in that "taking account of the possibility of a change in the discount rate." The way I would interpret that is that even though the Board of Governors may not decrease the discount rate right now, we will continue this process of leaning slightly on the easier side in open market operations, and maybe get down towards $200 million or so on borrowing, leaving aside the Oklahoma borrowing. If we do reduce the discount rate, not necessarily immediately, and we didn't like the repercussions on the exchange markets or some other things we leave open the possibility of increasing the borrowings slightly to, say, around the $400 million level. I think both of those [scenarios] are consistent with language that says easing slightly in terms of the overall picture, including the discount rate. That would leave a little flexibility on the open market side to either ease a bit if there's no discount rate change and, on a contingent basis but not on a planned basis, to tighten just a bit if that seems desirable in the way of exchange market reactions or domestic reactions. In either case, it's rather a small band.

MR. RICE. Mr. Chairman, what's the argument for easing on the open market operation side if we don't reduce the discount rate?

CHAIRMAN VOLCKER. I think it's a way of probing. Somebody suggested this as a way to get a bit of ease without making the overt move of a discount rate change. It's kind of a substitute but not a full substitute. It tests the waters as to what the exchange market reaction might be or whatever.

MR. RICE. That's not what I had in mind.

CHAIRMAN VOLCKER. I couldn't say that that is what anybody had in mind, but we are sitting here with a group that is going to make the decision--

MR. RICE. If I am going to ease, I want to lower the discount rate.

CHAIRMAN VOLCKER. In the terms that we used the last time that was easing. That's why I think this language we used the last time is suitable for either course. The only real difference I'm suggesting from that language, just to capture this a little more closely, is to change "decrease somewhat" to "decrease slightly." That's the tenor of the whole thing. The basic thrust is that some people might prefer to reduce the discount rate; but if there is no reduction in the discount rate, those who prefer to reduce the discount rate probably want a little easier stance in open market operations. Or vice versa: if we have the discount rate cut people may not prefer any easing [in open market operations]. Quite clearly, nobody has spoken of easing in open market operations plus the discount rate change.

MR. JOHNSON. I guess we could be very careful on the open market side but I am a little concerned that we could end up getting a pretty nasty effect in the bond market if we were to cut the discount rate and raise the borrowing level--maybe not, if we did it just a little around the edges in a way. I think we might get a steepening of the yield curve from an attempt to raise the borrowing level at the same time we cut the discount rate. I'd hate to see that.

CHAIRMAN VOLCKER. I'm not suggesting we do both at the same time. I'm just getting reactions. Presumably, if you want to argue for a steepening--of the Melzer school or the Stern school--I suppose you might say you would get an increase in the bond rates with the reduction in the discount rate.

MR. JOHNSON. Well, you might.

CHAIRMAN VOLCKER. I don't know which you would get, but I am not sure that you would get both at the same time.

MR. JOHNSON. I would like to see at least what happens to the yield curve independent of any changes in borrowing. Maybe if we think things are a little too aggressive as a result of that, we might want to change--

CHAIRMAN VOLCKER. That's what I am saying--take account of the major variable, which would be the exchange rate. If we didn't like that, give ourselves a little room to firm slightly.

MS. SEGER. How much of a move is it going to require in [unintelligible] move in the yen to 140?

CHAIRMAN VOLCKER. [Unintelligible] 140 in the week or we go to the devil. I think [at] 145 we would [unintelligible] going to the devil; 150 is not. But if we go beyond 150 in a very short period of time--

MR. CROSS. I think those numbers you mentioned are what people are now focusing on: 2 DM and 150 yen.

CHAIRMAN VOLCKER. I think we are prepared for going to 2 DM or 150 yen, but if it went suddenly beyond that I would get worried.

MR. MELZER. Did I detect less certainty in your description of discussions [with foreign central banks] about the discount rate this time? At the last meeting I felt it was pretty much a fait accompli. I might not have heard you just right, but--

CHAIRMAN VOLCKER. Oh, there has been none. I would expect nobody to follow us this time and--

MR. MELZER. I didn't mean that. I mean about whether or not we would do a discount rate cut--that perhaps there were other discussions that had to take place in an international context.

CHAIRMAN VOLCKER. I think there is a certain ambivalence as expressed around this table. That is right; I think you have made a correct distinction.

MR. MELZER. Just thinking in terms of that, would it not make sense to presume nothing in that regard and convene a conference call if a cut in the discount rate were to occur rather than to try to anticipate all of that? I don't know whether that--

CHAIRMAN VOLCKER. [Unintelligible] but I suspect that that decision will be reviewed this week. I feel a certain mechanical urgency to make a decision this week, one way or the other, because I am going to be out next week and a couple of days thereafter. We have to make a decision this week or, if we don't, I presume we are not going to make one for another week or so. But that's no argument. I think it is so close to the possibility, anyway, and I don't know what you do. [Unintelligible] everybody seems to be at $300 million for the moment, anyway. If we say it clearly is not going to happen for a couple of weeks, then we might ease. I think we are capable of deciding that today instead of--

VICE CHAIRMAN CORRIGAN. Without getting into a great [debate on] semantics here, when you talk about your formulation I interpret your shadings on the sides of $300 million as what I would think of as tilt. It's hard to capture what you are really saying here.

CHAIRMAN VOLCKER. I can't be more specific than around $200 million and around $400 million, but I don't want to take those too literally.

VICE CHAIRMAN CORRIGAN. You are putting them in a context in which both are obviously conditional on a matrix of other things.

CHAIRMAN VOLCKER. That's inevitably the case. But what I am saying is that if the exchange rate fell out of bed on its own in the next few days and we didn't reduce the discount rate, I don't suppose we would take that particular time to go to $200 million. But I assume if the exchange markets aren't doing anything [or if the dollar] particularly strengthened and we didn't reduce the discount rate I would.

MR. BLACK. You meant to exclude the special borrowing in Oklahoma from the $200 million, Mr. Chairman?

MR. ANGELL. Well, I certainly would have put a different context on it. If the discount rate were cut and if the dollar were under more pressure than we wanted and if we thought we wanted to make a gesture of intervention, I think it would be appropriate in that context also to go for a higher borrowing target. I don't want us to make an exchange rate move without in a sense backing it up a little. But I would not prefer cutting the discount rate and then just as the market gets used to a lower discount rate, boom, hit them with an increase in borrowing and knock the fed funds rate up. That's the part I don't want, but I--

CHAIRMAN VOLCKER. I did not say that we would just do it. I said it's contingent upon things happening that could be strong business news, but that takes a period of time.

MR. ANGELL. In the context of that I support your proposal.

CHAIRMAN VOLCKER. I am not talking anything very major here in either direction. That's a formulation that I propose here. If somebody has a better formulation, propose it.

MR. MORRIS. I would be more inclined to support a one-sided proposition that we stay with the $300 million. And if we cut the discount rate then I'd move borrowing to $400 million.

CHAIRMAN VOLCKER. I think that is consistent with your expressed view and the views of several other members of the Committee. But I don't detect that that will command unanimous support; if it does, then that's what we ought to say.

MR ANGELL. It won't get a majority.

CHAIRMAN VOLCKER. It is an obvious alternative. How many would prefer that kind of alternative?

MR. ANGELL. The one you suggested or Frank's?

MR. MORRIS. You are asking for votes of members?

CHAIRMAN VOLCKER. Members.

MR. MORRIS. If the discount rate gets cut, there is no point [unintelligible].

VICE CHAIRMAN CORRIGAN. I'd lean on the side of borrowing being higher rather than lower.

MR. RICE. With a cut in the discount rate.

CHAIRMAN VOLCKER. Well, how many prefer that course--at least other than Mr. Morris? Have we got any other alternatives to put on the table?

VICE CHAIRMAN CORRIGAN. The alternative "around $200 to $400 million," just hang around--

MR. JOHNSON. One other alternative is to just leave it at $300 million.

CHAIRMAN VOLCKER. Just leave it at $300 million and what? The problem with that is that people feel differently about whether there should be a discount rate cut or not.

MR. JOHNSON. Well, that's the alternative.

CHAIRMAN VOLCKER. I think the alternative is leaving it at $300 million regardless of whether we reduce the discount rate. That is a theoretical alternative.

MR. RICE. Theoretical?

CHAIRMAN VOLCKER. Well, I think it's more than theoretical. It leaves the whole decision in our hands. Would people prefer that?

VICE CHAIRMAN CORRIGAN. In some ways I would.

MR. JOHNSON. Yes, I would sort of prefer that.

MS. SEGER. I would.

MR. WALLICH. Not change it?

MR. JOHNSON. Yes, just leave borrowing at $300 million whether we cut the discount rate or not.

MR. RICE. Leave it at $300 million with the discount rate cut or not.

MR. MELZER. I would be happy with that if there were a call at the time. Wouldn't it raise the question as to what to do with the borrowing level at that time?

MR. ANGELL. No.

MR. JOHNSON. No, it's saying that you're willing to accept $300 million on borrowing regardless of what the discount rate--

MR. BOEHNE. It's basically shifting the decision of the discount rate.

MR. MELZER. Yes, but the fact is that, in effect, it is the same thing given the high degree of probability of a discount cut happening. I don't think--

MR. BLACK. You're giving up the $400 million possibility if you vote for that.

MR. JOHNSON. What you're really saying is that there's not a whole lot of difference between $300 million borrowing and no discount rate cut and $300 million borrowing with a 1/2 point cut.

MR. BOEHNE. Well, there's a 50 percentage point drop in the funds rate, right?

MR. JOHNSON. I know. I'm just saying that you would have to believe that that margin didn't mean a lot.

MR. PARRY. Isn't one possibility just to maintain the $300 million and when a discount rate change occurs, if it does, to revisit the issue of reserves at that time?

CHAIRMAN VOLCKER. I'm just a little reluctant; if we can't anticipate a reaction three days from now we're in pretty sad shape.

I am not saying we would automatically go to $400 million with a discount rate reduction. I simply would leave ourselves that room if it appears desirable in the light of events subsequent to the [rate cut].

MR. BOEHNE. What about this? The discount rate decision is clearly a separate decision. And however that decision is made we would think that the Chairman would have the normal discretion that we've become used to in recent years in adjusting the borrowing.

CHAIRMAN VOLCKER. I would say this is all within the range of a certain amount of discretion. What's a little more sensitive is the numbers we get when the percentage change in the borrowing gets larger. It seems to be a matter of greater sensitivity, understandably perhaps. I don't care if we do it; that's what I started out with. But I'm trying to capture a little more closely a center of gravity.

MR. ANGELL. I prefer leaving the borrowing at $300 million as an initial part of the approach. If the circumstances are such that we don't cut the discount rate I don't want to take the borrowing down to $200 million. If we do cut the discount rate, I prefer that borrowing be at $300 million but I would want there to be latitude that if developments then require a higher borrowing level that we would do that. If we ever got ourselves in a position of wanting a discount rate increase we probably would precede that first by taking the borrowing from $300 million up to $400 million and $500 million and then we would condition the market that we think it's time to increase [the discount rate].

CHAIRMAN VOLCKER. That's correct. We're just talking about timing. Just to repeat what I said on that theory: I'm saying we might have the flexibility to do that depending upon subsequent developments. The other thing is that I am not saying we reduce the discount rate on day A and raise borrowing on day A. Also, just to be clear, I'm saying we don't reduce it to $200 million tomorrow when we're going to make a discount rate decision one way or another later this week. If we do not make a decision to reduce it that would imply slightly easier borrowing numbers for a while pending whether we make a decision a little later.

MR. JOHNSON. Okay, I could see that. That's fine.

MR. GUFFEY. With that understanding, I would agree.

CHAIRMAN VOLCKER. I think you will agree--

MR. ANGELL. Mr. Chairman, I think that if you put that out as a proposal it will pass.

CHAIRMAN VOLCKER. What it means in terms of language is this: to say "decrease slightly" instead of "somewhat" probably captures it a little more closely. But we would leave in this language "taking account of the possibility of a discount rate change." Now, I don't know what numbers to put in here, because our staff is telling us that we're at least in grave jeopardy of exceeding the 9 percent. Whether we want to admit that or not, I don't know. We could leave the 7 to 9 percent.

MR. JOHNSON. Yes, I would just leave that.

MR. ANGELL. I'd leave it.

CHAIRMAN VOLCKER. I think we're saying that one of the considerations, and it is only one of the considerations, is that we're looking at that contingency of whether we reduce the discount rate or not. The option to slightly tighten reserve conditions would depend at least in part upon whether M2 and M3 continued to zoom with M1 continuing to zoom.

MR. WALLICH. But it would be a pretty large increase.

CHAIRMAN VOLCKER. It sure would be, relative to what has been happening. That is one of the factors; the directive says it. If we came out with 10 to 11 percent growth in M2 and M3 that would certainly be a consideration in moving toward the higher borrowing level. I think that's what we would be saying. Understood? And the same [language on] M1 follows that. I don't care if we use "might" or "would;" it makes no difference here. The trouble with this is it's exactly the directive we had last time. And I don't know what it--

MR. BLACK. Well, you changed "somewhat" to "slightly."

CHAIRMAN VOLCKER. I suppose we leave in the 4 to 8 percent. Any other questions? The language couldn't be simpler: change "somewhat" to "slightly;" leave in "taking account the possibility of a discount rate change;" and the rest of the language remains as it was in the last directive. The understanding is that tomorrow we do nothing--stay at $300 million--and that the discount rate will obviously be considered later this week. If we reduce the discount rate we still do nothing in the [unintelligible] but, depending upon developments, we might use a little flexibility on the up side. If we don't reduce the discount rate we might use a little flexibility on the down side but very slightly depending on what [unintelligible] but we're close to that now. Understood? Just call the roll, sir.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	Yes
President Horn	Yes
Governor Heller	Yes
Governor Johnson	Yes
President Melzer	No
President Morris	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	No

CHAIRMAN VOLCKER. I think we have completed our business. Do we have sandwiches?

MR. BERNARD. Yes.

END OF MEETING